

DOCKET SECTION

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

RECEIVED
APR 1 4 30 PM '98
POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY
Docket No. R97-1

POSTAL RATE AND FEE CHANGES, 1997)

INITIAL BRIEF

OF

NASHUA PHOTO INC., DISTRICT PHOTO INC.,
MYSTIC COLOR LAB, SEATTLE FILMWORKS, INC., AND
MERCK-MEDCO MANAGED CARE, L.L.C.

William J. Olson
John S. Miles
Alan Woll
John F. Callender, Jr.
WILLIAM J. OLSON, P.C.
8180 Greensboro Dr., Suite 1070
McLean, Virginia 22102-3823
(703) 356-5070

Counsel for Nashua Photo Inc.,
District Photo Inc.,
Mystic Color Lab,
Seattle FilmWorks, Inc., and
Merck-Medco Managed Care, L.L.C.

April 1, 1998

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

POSTAL RATE AND FEE CHANGES, 1997)

Docket No. R97-1

INITIAL BRIEF

OF

NASHUA PHOTO INC., DISTRICT PHOTO INC.,
MYSTIC COLOR LAB, SEATTLE FILMWORKS, INC., AND
MERCK-MEDCO MANAGED CARE, L.L.C.

William J. Olson
John S. Miles
Alan Woll
John F. Callender, Jr.
WILLIAM J. OLSON, P.C.
8180 Greensboro Dr., Suite 1070
McLean, Virginia 22102-3823
(703) 356-5070

Counsel for Nashua Photo Inc.,
District Photo Inc.,
Mystic Color Lab,
Seattle FilmWorks, Inc., and
Merck-Medco Managed Care, L.L.C.

April 1, 1998

TABLE OF CONTENTS

	<i>Page</i>
TABLE OF AUTHORITIES	vii
STATEMENT OF THE CASE	
Course of Proceedings	1
The Postal Service's Request	3
Reliance of the Postal Service on Unsponsored Library References . . .	5
Discovery of the Postal Service's Case-in-Chief	7
NDMS Testimony and Proposals	8
Direct Testimony of Other Intervenors	9
NDMS Discovery of Other Intervenors	11
Rebuttal of Testimony Relating to NDMS Positions	11
SUMMARY OF ARGUMENT	13
ARGUMENT	
I. THE FIRST-CLASS NONSTANDARD SURCHARGE SHOULD BE ABOLISHED OR REDUCED	
A. Current DMCS and DMM Provisions define First-Class Nonstandard Mail Which is Subject to a Surcharge	17
1. Letters	18
2. Flats	20
3. Parcels	20

B.	History of the First-Class Nonstandard Surcharge and the Need for Its Reassessment	21
C.	The Postal Service's Case-in-Chief Contains No Evidence of a Valid Reason for Increasing the Surcharge or Even for Continuing the Surcharge	24
D.	Dr. Haldi Demonstrates that Postal Service Mail Processing Has Advanced to the Point where the First-Class Nonstandard Surcharge is No Longer Needed	29
E.	Witness Sheehan Demonstrates that the First-Class Nonstandard Surcharge is No Longer Needed	31
F.	First-Class Nonstandard Volumes and Revenues Do Not Justify the Existence of a Surcharge	34
G.	In the Alternative, the Amount of the Current First-Class Nonstandard Surcharge Should Be Reduced	37
II.	PRIORITY MAIL RATES SHOULD BE MODIFIED	
A.	The Maximum Weight of First-Class Mail Should Be Increased	45
B.	An Alternative Procedure for Priority Mail Volume and Revenue Projections Is Necessary	48
1.	The Postal Service's Method for Projecting Test Year After Rates Volumes for Priority Mail Ignores the Effects of Rate Design, Produces Misleading Forecasts, and Should Be Changed	49
2.	Rate Cell Volume and Revenue Projections Under Dr. Haldi's Proposed Alternative Procedure Would Depend Upon Rate Design, as They Should	50
C.	The Postal Service Needs Better Cost-based and Competitive Priority Mail Rates	51

	<i>Page</i>
1. Distance-Related Transportation Costs Should Not Be Marked up	52
2. The Hidden Surcharge on Zoned Priority Mail Should Be Eliminated	53
3. Uniform Incremental Rates for 2- to 5- Pound Priority Mail Pieces Should Be Retained	57
4. Presort Discounts Should Be Eliminated	58
5. The Postal Service's Proposed Rates for Delivery Confirmation Should Be Adopted	58
6. No Shape-based Surcharge Should Be Imposed on Priority Mail	61
 D. The Coverage Factor for Priority Mail Should Not Be Increased	
1. Priority Mail's Delivery Performance Is Not Good and the Postal Service's Estimation of Priority Mail's Value of Service Is Too High	63
2. Priority Mail Is Losing Ground in a Highly Competitive Market Because it Falls Short of its Delivery Standards, and Lacks the Features of Many Nonpostal Products with Which it Competes	64
3. The Priority Mail Processing Center Contract Has Increased Costs, and Will Likely Degrade Service . . .	66
a. The Postal Service Underestimated the Cost Savings Caused by the Priority Mail Processing Center Contract	67
b. Service for Priority Mail Will Likely Degrade as a Result of the Priority Mail Processing Center Contract	70
 E. The Commission Should Recommend the Rates for Priority Mail Proposed by NDMS	71

III.	THE POSTAL SERVICE'S STANDARD A RESIDUAL SHAPE SURCHARGE SHOULD BE REJECTED	73
A.	The Postal Service Proposal Does Not Meet the Standards Set by the Commission in Docket No. MC95-1 for Future Standard A Parcel Rate Design	74
1.	The Postal Service's Proposal Does Not Address the Alleged "Below Cost-Rate Problem"	75
a.	The "Below Cost-Rate Problem" of Standard A Regular Parcels Keeps Diminishing	77
b.	The "Below Cost-Rate Problem" of Standard A "Commercial" Parcels Keeps Diminishing	78
c.	The Postal Service's Proposal Does Not Acknowledge that the "Below Cost-Rate Problem" is Disappearing	78
2.	The Postal Service Has Not Presented its Analysis of Market Characteristics, and the Volume and Revenue Estimates from the Surcharge Appear to be Grossly Inflated	79
3.	The Postal Service's Proposal Does Not Address Concerns Raised by RIAA and PSA in Docket No. MC95-1	80
a.	There Is Still No Record Evidence that Shape Is a Dominant Cost Influence in Mail Handling or that Parcels Are Systematically More Costly to Handle than Flats	81
b.	The Postal Service's Proposal Fails to Address the Fact That Some Parcels Have Shapes that Are Far Closer to the Shape of Flats than to the Shape of Other Parcels	84

c.	The Postal Service's Proposal Still Lacks Adequate Definition Parameters of Affected Mailpieces, Identification of the Different Procedures (and Resultant Costs) for Machinable and Nonmachinable Parcels, and an Analysis of Potential Volume Shifts Resulting from the Surcharge	
i.	The Postal Service's Proposal Still Lacks Adequate Definition Parameters of Affected Mailpieces	86
ii.	The Postal Service's Proposal Still Fails to Distinguish Between Machinable and Nonmachinable Parcels	90
iii.	The Postal Service's Proposal Still Lacks Any Analysis of Potential Volume Shifts Resulting from the Surcharge	90
iv.	Calculation of the "Average Cost" of a "Parcel" Still Proves Nothing About the Range of Costs that Made Up that Average	91
B.	The Record in this Docket Does Not Support the Proposed Surcharge	
1.	Substantial Rebutted Testimony Show the Data on Which the Surcharge Is Premised Are Unreliable	94
2.	The Postal Service Attempted to Rebut the Criticisms of Only One Intervenor Adverse to the Surcharge	97
3.	The Focus on Costs Incurred by Shape, While Ignoring Costs Avoided by Shape, by Refusing to Permit Dropship Discounts, Is Inconsistent, Unfair, and Inequitable	99

	<i>Page</i>
C. The Postal Service's Proposed Standard A Residual Shape Surcharge Does Not Consider Rate Shock on Standard A Parcel Mailers	103
D. The Postal Service Proposal Does Not Meet the Statutory Standards For Mail Classification and Rate Design	105
1. The Postal Service's Proposed Surcharge Does Not Promote a Fair and Equitable Classification System for All Mail Under 39 U.S.C. Section 3623(c)(1) . .	105
2. The Postal Service Has Not Demonstrated the Desirability of or Justification for this New Classification Under 39 U.S.C. Section 3623(c)(2) .	106
E. The Proposed Surcharge May Result in Unintended and Undesirable Consequences	107
F. NDMS and Merck-Medco Recommendations	110
1. The Commission Should Create a Shell Classification	110
2. The Surcharge Should not be More than 2 or 3 Cents	110
3. The Commission Should Create Separate Destination Entry Discounts for Parcels, Reflecting the Avoidance of Greater Costs	111
CONCLUSION	112

TABLE OF AUTHORITIES

Statutes

39 U.S.C. sections 3622 and 3623	1
39 U.S.C. section 3622(b)	34,61
39 U.S.C. section 3622(b)(7)	34
39 U.S.C. section 3623(c)	14,15,35,105
39 U.S.C. section 3623(c)(1)	105
39 U.S.C. section 3623(c)(2)	106

Regulations

39 C.F.R. section 3001.20(a)	2
39 C.F.R. section 3001.54(j)	46, 47, 49

Domestic Mail Classification Schedule

Section 232	16
Section 1002	16
Section 6020	17

Opinions and Recommended Decisions

Docket No. MC73-1	20,21,22,25
Docket No. R74-1	45
Docket No. R78-1	20,26,28
Docket No. R80-1	21

Docket No. R84-1	21
Docket No. R87-1	21,43,44
Docket No. R90-1	21,103,111
Docket No. R94-1	21, <i>passim</i>
Docket No. MC95-1	15, <i>passim</i>

Domestic Mail Manual

DMM section C100.4.0	16
DMM section C050.2.0	17
DMM section C050.30	19
DMM section C050	85,88

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

POSTAL RATE AND FEE CHANGES, 1997)

Docket No. R97-1

INITIAL BRIEF

OF

NASHUA PHOTO INC., DISTRICT PHOTO INC.,
MYSTIC COLOR LAB, SEATTLE FILMWORKS, INC., AND
MERCK-MEDCO MANAGED CARE, L.L.C.

STATEMENT OF THE CASE

COURSE OF PROCEEDINGS

On July 10, 1997, the United States Postal Service filed a request, pursuant to the Postal Reorganization Act (39 U.S.C. sections 3622 and 3623), for a recommended decision by the Postal Rate Commission on certain rates and fees, including proposals relating to First-Class Mail, Priority Mail, and Standard A Mail, as well as certain changes to the Domestic Mail Classification Schedule.

On July 11, 1997, the Commission issued a Notice of Filing of the Postal Service's submission, which Notice of Filing, *inter alia*, established procedures for the new docket (designated Docket No. R97-1) regarding consideration of the requested changes by the Commission (Order No. 1186).¹

¹ This case was to have been submitted to the Commission on brief by March 13, 1998. See Presiding Officer's Ruling ("P.O. Ruling") No. R97-1/4 (Aug.

In accordance with Order No. 1186 and Rule 20a of the Commission's Rules of Practice and Procedure (39 CFR section 3001.20a), Nashua Photo Inc. ("Nashua"), District Photo Inc. ("District"), Mystic Color Lab ("Mystic"), and Seattle FilmWorks, Inc. ("Seattle") each filed its respective Notice of Intervention on July 11, 1997.² These intervenors have proceeded jointly in this proceeding, and are referred to collectively as "NDMS." Merck-Medco Managed Care, Inc. ("Merck-Medco") filed its Notice of Intervention on August 13, 1997. Merck-Medco co-sponsored with NDMS the direct testimony of Dr. John Haldi (NDMS-T-3) in opposition to the Postal Service's proposed parcel surcharge, and as discussed *infra*, joins in Section III of this brief.³

1, 1997). Subsequently, however, certain discovery problems, occasioned by the efforts of Postal Service witnesses to rely on unsponsored library references, were resolved by the Commission, allowing the Postal Service to supplement its case-in-chief. See Order No. 1201 (Nov. 4, 1997), p. 17. This led to additional discovery and resulting changes in some of the target dates set forth in Order No. 1186, with the deadlines for filing initial and reply briefs extended to April 1 and April 10, 1998, respectively. See P.O. Ruling No. R97-1/54 (Nov. 4, 1997) and P.O. Ruling No. R97-1/55 (Nov. 5, 1997).

² Although not an intervenor in this proceeding, Skrudland Photo Inc. has supported this litigation and joins in the positions taken by the intervenor photofinishers.

³ NDMS incorporate herein by reference their Trial Brief filed in this proceeding on February 10, 1998.

The Postal Service's Request

The Postal Service's Request for a Recommended Decision initiated this proceeding for proposed rate and fee changes affecting all classes of mail, and asserted that without those changes the Postal Service would incur a revenue deficiency of \$2.4 billion in the proposed test year (FY 1998). According to the Postal Service's initial filing, the proposed rates would generate a revenue surplus of approximately \$41.9 million in the test year.⁴

The following paragraphs address the three proposals in the Postal Service's Request which are of particular importance to NDMS in this proceeding.

First-Class Nonstandard Surcharge

The Postal Service proposes to increase the rate for the first ounce of First-Class Mail from 32 to 33 cents, or by **3.1 percent**, and to increase the surcharge applicable to single-piece nonstandard pieces one ounce and under by 5 cents, from 11 to 16 cents, or by **45 percent**. This 45 percent increase represents a ten-fold increase over the system-wide average of 4.5 percent in this omnibus rate case.⁵ NDMS has sponsored

⁴ The estimated TYAR revenue surplus was later reduced to \$35.6 million. USPS-T-9, p. 47 (revised 8/22/97).

⁵ See Direct Testimony of Dr. John Haldi, NDMS-T-1, p. 7, Tr. 24/12880. As pointed out by Dr. Haldi, the magnitude of this 45 percent increase is exceeded in this proceeding only by the increases of up to 55.6 percent proposed by the Postal Service for Standard A parcels, and the increases proposed by the Postal Service for registered mail. *Id.*, p. 7, fn. 2, Tr. 24/12880.

testimony opposing the Postal Service's proposal and supporting an alternative proposal to abolish (or reduce) the First-Class nonstandard surcharge.

Priority Mail

The Postal Service has proposed a number of changes affecting Priority Mail, including higher rates, elimination of the presort discount, and initiation of delivery confirmation service. The Postal Service's average proposed rate increase for Priority Mail is approximately 7.4 percent. NDMS has sponsored testimony proposing a superior Priority Mail rate design methodology, alternative rates for Priority Mail itself, and a classification proposal to increase the maximum rate of First-Class Mail.

Proposed Standard A Mail Parcel Surcharge

In addition to proposing Standard A Regular rate increases that approach 10 percent, the Postal Service's Standard A Mail rate design witness has proposed a 10 cent per-piece surcharge on residual Standard A Mail (*i.e.*, mailpieces that are neither letter-shaped nor flat-shaped, *inter alia*). As discussed, *infra*, this surcharge would increase the rate for certain Standard A Regular pieces by 55.1 percent. NDMS has sponsored testimony pointing out the substantial defects in the proposed surcharge, and recommending that it be rejected (or, in the alternative, substantially reduced).

Reliance of the Postal Service on Un-sponsored Library References

During the course of discovery of the Postal Service's case-in-chief, it became apparent that several Postal Service witnesses relied on unsponsored library references that would not be admitted as part of the evidentiary record in this proceeding. A number of parties, including NDMS, moved to strike portions of the testimony offered by the Postal Service, since the witnesses' testimony should not be admissible in evidence if the purported foundation for the witnesses' testimony were not admitted in evidence.⁶ The Postal Service ultimately decided to offer sponsors for the documents.

⁶ The discovery disputes involved a number of motions and various P.O. Rulings over several weeks, and may be said to have culminated in the filing by various parties of three separate, but substantially related, motions for relief, including the NDMS "Motion to Strike Specific Portions of the Testimony of Various Postal Service Witnesses and Certain Library References, and for Other Relief."

In the introductory section of their motion, NDMS framed the issue of serious prejudice created by the Postal Service's actions, as follows:

From the outset of the hearings on the Postal Service's case, the dominant issue confronting the Commission has been how to proceed in light of the heavy reliance on non-record, unsponsored library references by many Postal Service witnesses. After many weeks of motions practice challenging the admissibility in evidence of certain unsponsored Postal Service library references and correspondingly inadequate witness testimony, the Presiding Officer established a final deadline — October 14, 1997 — for the Postal Service to list those currently unsponsored library references it intends to introduce into evidence, together with a list of witnesses who would sponsor those library references. *See* Presiding Officer's Ruling No. R97-1/42. In response, the Postal Service has listed some 49 newly-sponsored library references and more than a dozen sponsoring witnesses, including three new witnesses, in these proceedings. The Postal Service also stated that it was "in the process of inquiring about availability of individuals who would be in a position to testify as to other

Despite the fact that this issue was not resolved until months after the institution of this case and toward the end of the time for discovery on the Postal Service's case-in-chief, the Commission allowed the Postal Service to offer such sponsors. *See* Order No. 1201 (November 4, 1997), pp. 17, 20. This delayed certain aspects of the proceedings, and led to extensions of discovery dates and a tremendous amount of effort by all parties.

It was, and is, the NDMS position that, at the time the Postal Service filed its Request, the Postal Service did not have competent evidence to support its proposals to increase the First-Class nonstandard surcharge and to create a Standard A residual shape surcharge. Furthermore, notwithstanding the Commission's Order No. 1201, the Postal Service has not been able to rehabilitate the inadequate showing it has made with respect to these proposals.

library references...." Clearly the list filed with the Commission is not final in any sense.

Therefore, as of today, with less than a week remaining in the originally scheduled hearings for cross-examination of Postal Service witnesses, the parties still have no idea of what the Postal Service's case-in-chief will eventually contain.

The Presiding Officer certified all three motions to the full Commission which, on October 27, 1997, ordered that additional discovery could be directed to recently identified supplemental Postal Service witnesses (Order No. 1200), and on November 4, 1997, ruled that the Postal Service would be permitted effectively to amend its filing by the addition of supplemental witnesses and newly-sponsored library references (Order No. 1201).

Discovery of the Postal Service's Case-in-Chief

Counsel for NDMS conducted written cross-examination of the following 10

Postal Service witnesses with respect to their direct testimony:

First-Class Nonstandard Surcharge

- USPS Witness Moden (USPS-T-4)
- USPS Witness Seckar (USPS-T-26)
- USPS Witness Daniel (USPS-T-29) (USPS-ST-43)
- USPS Witness Fronk (USPS-T-32)

Priority Mail

- USPS Witness Patelunas (USPS-T-15)
- USPS Witness Sharkey (USPS-T-33)

Proposed Standard A Parcel Surcharge

- USPS Witness Crum (USPS-T-28)
- USPS Witness Moeller (USPS-T-36)

Miscellaneous

- USPS Witness Degen (USPS-T-12)
- USPS Witness Schenk (USPS-T-27)

Counsel for NDMS conducted oral cross-examination of the following nine

Postal Service witnesses with respect to their direct testimony, which appears in the record at the identified pages:

First-Class Nonstandard Surcharge

- USPS Witness Seckar Tr. 18/8220-42

- USPS Witness Daniel Tr. 14/7419-98
- USPS Witness Fronk Tr. 4/1630-62

Priority Mail

- USPS Witness Tayman Tr. 9/4524-46
- USPS Witness Patelunas Tr. 13/7312-25
- USPS Witness O'Hara Tr. 2/402-23
- USPS Witness Sharkey Tr. 4/2100-23

Proposed Standard A Parcel Surcharge

- USPS Witness Crum Tr. 5/2358-70; 17/8071-119
- USPS Witness Moeller Tr. 6/2935-53

NDMS Testimony and Proposals

NDMS sponsored three pieces of testimony by their expert witness, Dr. John Haldi. This testimony, all of which was filed on December 30, 1997, was as follows:

- Direct Testimony of Dr. John Haldi concerning the First-Class Nonstandard Surcharge (NDMS-T-1), admitted in evidence on February 23, 1998 (Tr. 24/12872-12923).⁷ His oral cross-examination is at Tr. 24/12928-41;

⁷ Dr. Haldi responded to 11 discovery requests from the Postal Service and one from OCA with respect to NDMS-T-1. The single discovery response designated for inclusion in the record is set forth at Tr. 24/12927.

- Direct Testimony of Dr. John Haldi concerning Priority Mail (NDMS-T-2), admitted in evidence on February 17, 1998 (Tr. 20/10292-10411).⁸ His oral cross-examination is at Tr. 20/10488; and
- Direct Testimony of Dr. John Haldi concerning the Proposed Standard Mail A Parcel Surcharge (NDMS-T-3), additionally co-sponsored by Merck-Medco, and admitted in evidence on February 20, 1998 (Tr. 23/12130-12175).⁹ His oral cross-examination is at Tr. 23/12242-71.

Direct Testimony of Other Intervenors

First-Class Nonstandard Surcharge

No other parties filed testimony directly supporting or opposing the proposed surcharge on First-Class nonstandard pieces.¹⁰

⁸ Dr. Haldi responded to 32 discovery requests from the Postal Service, and 14 from United Parcel Service with respect to NDMS-T-2. Errata to this testimony were subsequently filed, and the revisions are contained in the transcript with respect to this testimony regarding Priority Mail, and the discovery responses designated for inclusion in the record, are set forth at Tr. 20/10416-87.

⁹ Dr. Haldi responded to 46 discovery requests from the Postal Service with respect to NDMS-T-3. The testimony was revised with minor errata. The discovery responses designated for inclusion in the record are set forth at Tr. 23/12180-241.

¹⁰ The testimony of witness Jellison on behalf of Parcel Shippers Association (PSA-T-1), in discussing shape-based rates, mentioned the First-Class nonstandard surcharge as an illustration, but took no position on the surcharge. *See* PSA-T-1, p. 24, Tr. 24/12968. That testimony also includes statements regarding, *inter alia*, of nonstandard First-Class volumes by shape which were in error and were corrected by errata.

Priority Mail

The only other intervenor to file testimony directly pertaining to Priority Mail was the Postal Service's competitor, United Parcel Service ("UPS"). The testimony of UPS witnesses Sellick (UPS-T-2), Henderson (UPS-T-3), and Luciani (UPS-T-4) seek increases in all Priority Mail rates. UPS proposes that \$300 million in additional mail processing costs be attributed to Priority Mail, that an additional fee for Priority Mail delivery confirmation be charged, and that a surcharge of 10 cents should be imposed on all Priority Mail parcels.

Proposed Standard A Parcel Surcharge

No other parties filed testimony supporting the Postal Service's proposed Standard A Mail residual shape surcharge. Several parties, as well as NDMS, sponsored testimony opposing the proposed parcel surcharge.

The Recording Industry Association of America (RIAA) and the Advertising Mail Marketing Association (AMMA) sponsored testimony by witness Andrew (RIAA, *et al.*-T-1, Tr. 22/11645-78), which criticizes the analysis of witness Crum in support of the proposed surcharge (USPS-T-28). Witness Andrew's oral cross-examination appears at Tr. 22/11715-31.

The Parcel Shippers Association (PSA) sponsored the testimony of its Executive Vice President (witness Jellison) in opposition to the Standard A Mail residual shape surcharge (PSA-T-1, Tr. 24/12943-78). Witness Jellison also criticizes the analysis of witness Crum (USPS-T-28), objects to the Postal Service's practice of combining mailpieces from four different subclasses to develop a single rate, and states that the

Postal Service has not adequately considered the rate shock that would result from its proposal. His oral cross-examination appears at Tr. 24/13054-59.

NDMS Discovery of Other Intervenors

Priority Mail

NDMS conducted written and oral cross-examination of the following UPS witnesses:

- UPS Witness Henderson, UPS-T-3, on February 24, 1998 (Tr. 25/13635-44); and
- UPS Witness Luciani, UPS-T-4, on February 25, 1998 (Tr. 26/14446-50).

Rebuttal Testimony Relating to NDMS Positions

First-Class Nonstandard Surcharge

The only rebuttal testimony offered in response to the testimony of NDMS witness Haldi with respect to the First-Class nonstandard surcharge was that of Postal Service witness Sheehan (USPS-RT-16), who confined his testimony to the subject of First-Class nonstandard letters, as opposed to First-Class nonstandard flats and nonstandard parcels. Counsel for NDMS cross-examined witness Sheehan on March 17, 1998 on his rebuttal testimony (Tr. 33/17380-424, 17434-35, and 17439).

Priority Mail

No Postal Service, OCA, or intervenor witnesses offered testimony attempting to rebut the testimony of NDMS witness Haldi with respect to Priority Mail.

Proposed Standard A Parcel Surcharge

No Postal Service, OCA or intervenor witnesses offered testimony attempting to rebut the testimony of NDMS witness Haldi regarding his proposal that the proposed Standard A parcel surcharge be rejected.

SUMMARY OF ARGUMENT

NDMS believe that the Postal Service's proposals are deficient in several particulars, and should be rejected or modified in accordance with the recommendations contained in the testimony of Dr. John Haldi.

First, NDMS oppose the First-Class nonstandard surcharge. The Postal Service has recommended that the First-Class single-piece nonstandard surcharge — a charge that is difficult to justify even at the current rate — be increased from 11 cents to 16 cents per piece. *This 45 percent increase would cause severe rate shock to* NDMS and other mailers of First-Class nonstandard pieces. Not only should the proposed surcharge increase and the associated increase for presort nonstandard pieces not be recommended; the overwhelming weight of the evidence supports elimination of the surcharge altogether.

The Postal Service has furnished no reliable cost data supporting a First-Class nonstandard surcharge, which is based upon the theory that it costs more for the Postal Service to process certain one-ounce-and-under First-Class pieces. The Postal Service has assumed but not demonstrated that there are significant additional costs associated with processing nonstandard pieces. Furthermore, the cost data themselves are speculative. The Postal Service admits that it has no data with respect to the processing costs of one-ounce-and-under nonstandard pieces, and that its cost data are based upon proxies involving the processing costs of “manual letters” and “average” (and much heavier) First-Class flats and parcels.

As NDMS witness Haldi has pointed out in his testimony, and as demonstrated by his study and experiments, the Postal Service's mail processing equipment is much more sophisticated today than when the nonstandard surcharge was adopted in the 1970s (when low-weight nonstandard pieces probably did cost somewhat more to process). Today, the great bulk of nonstandard letters are in fact processed on the Postal Service's highly-efficient letter automation equipment, a phenomenon that the Postal Service simply has failed to study or account for. This fact, was confirmed by the Postal Service's own rebuttal witness Sheehan. Likewise, nonstandard flats are efficiently handled on flat sorting machines, while otherwise letter shaped pieces which are so thick as to be flats or parcels are handled as manual letters. The Postal Service's own evidence, coupled with Dr. Haldi's testimony supports elimination of, or a significant reduction in, the current First-Class nonstandard surcharge.

Second, NDMS submit that the proposed Priority Mail rates should be modified. NDMS also submitted the testimony of Dr. John Haldi in support of their proposals related to Priority Mail. NDMS propose a comprehensive rate schedule for Priority Mail, with several advantages over both current rates and the Postal Service's proposed rates. NDMS's proposed rates do not include a mark-up on distance-related transportation costs, which should serve to prevent further loss of market share for zoned 6- to 70-pound Priority Mail.

NDMS propose that the Commission recommend a classification change raising the maximum weight of First-Class Mail to 13 ounces. This would solve the problem of the increasing rate gap between First-Class Mail and Priority Mail. NDMS also

propose an alternative, more realistic method for projecting Test Year After Rates volumes, one which will allow the Commission to consider the full effects of rate design on volume.

Third, NDMS oppose the proposed Standard A parcel surcharge. The Postal Service has proposed a single, 10 cent, residual shape surcharge to be imposed on all nonletter/nonflats from four separate subclasses: Standard A Regular, Standard A ECR, Standard A Nonprofit, and Standard A Nonprofit ECR. This proposal does not meet the standards of the Postal Reorganization Act, and is not responsive to the request made by the Commission (in its *Opinion & Recommended Decision*) for a Standard A parcel rate in Docket No. MC95-1.

The Postal Service's proposed residual shape surcharge has received no support whatsoever from any source in this docket. All elements of the mailing community which have addressed the Postal Service's proposal have expressed opposition. Intervenor witnesses Haldi (NDMS-T-3), Jellison (PSA-T-1), and Andrew (RIAA, *et al.*-T-1) have exposed a litany of miscalculations, questionable cost data, inconsistencies in data collection, and gaps in the Postal Service's analysis — and nearly all of these criticisms remain unrebutted.

The incompleteness of the Postal Service's filing (notwithstanding repeated efforts to rehabilitate its proposal) is also evident from a comparison of the data and analyses requested by the Commission in its examination of the "below cost-rate problem" in Docket No. MC95-1, to the information provided by the Postal Service in this docket. The Postal Service would not even tie its proposed surcharge to the

continued existence of a “below cost-rate problem.” (This may be due, in part, to evidence indicating that Standard A Regular parcels — 8.5 percent of total Standard A parcel volume in the Base Year — generate revenues that exceed their costs incurred.)

ARGUMENT

I. THE FIRST-CLASS NONSTANDARD SURCHARGE SHOULD BE ABOLISHED OR REDUCED

A. Current DMCS and DMM Provisions Define First-Class Nonstandard Mail Which is Subject to a Surcharge

The Domestic Mail Classification Schedule (“DMCS”) authorizes a surcharge on certain letter, flat, and parcel-shaped First-Class Mail defined as “nonstandard,” as follows:

232 Nonstandard Size Mail¹¹

Letters and Sealed Parcels subclass mail weighing one ounce or less is nonstandard size if:

- a. Its aspect ratio does not fall between 1 to 1.3 and 1 to 2.5 inclusive; or
- b. It exceeds any of the following dimensions:
 - i. 11.5 inches in length;
 - ii. 6.125 inches in width; or
 - iii. 0.25 inch in thickness.

The term “**aspect ratio**” is defined as “the ratio of width to length” in section 1002 of the DMCS. Accordingly, there are four ways in which a First-Class piece can be nonstandard — three relating to **maximum** dimensions (length, width, and thickness), and one relating to the “aspect ratio.” NDMS’ proposal herein would completely eliminate the First-Class nonstandard surcharge, or, in the alternative, significantly reduce the amount of the nonstandard surcharge.

It should be noted that certain small First-Class Mail pieces which are presumably difficult to process on letter machinery are currently prohibited from the

¹¹ The corresponding provision in the Domestic Mail Manual is section C100.4.0.

mailstream. The DMCS specifies that all mailable matter must meet the following **minimum** size standards:

6020 Minimum Size Standards

The following minimum size standards apply to all mailable matter:

- a. All items must be at least 0.007 inches thick, and
- b. All items other than keys and identification devices, which are 0.25 inch thick or less, must be:
 - i. rectangular in shape,
 - ii. at least 3.5 inches in width, and
 - iii. at least 5 inches in length.

NDMS' proposal herein does not reach these very small pieces at all. They would continue to be completely prohibited.

Pieces currently subject to the First-Class nonstandard surcharge should be analyzed as three separate mail groups: letters, flats and parcels.

1. Letters

Surprisingly, the DMCS does not define the term "letter" or "letter-sized," although both terms are used. The Domestic Mail Manual (DMM) does define a "letter", in section C050.2.0, as follows:

Except under 3.2 [relating to automation], letter-size mail is...:

- a. Not less than 5 inches long, 3½ inches high, and 0.007 inch thick.
- b. Not more than 11½ inches long, 6 1/8 inches high, and 1/4 inch thick.

As discussed, *supra*, with respect to the **minimum** dimensions of a letter, 3½ inches high by 5 inches long, and 0.007 inches thick, pieces not meeting these criteria are nonmailable, and hence are not subject to a nonstandard surcharge. (Since the

minimum dimensions of a letter are expressed in terms of nonmailability, they do not distinguish between a letter and a nonstandard letter.)

The **maximum** dimensions of a nonstandard letter, 6 1/8 inches high by 11½ inches long, and 1/4 inch thick, are no different from the maximum dimensions of a letter. In other words, a letter does not become a nonstandard letter due to excessive height, length, or thickness. Whenever a letter exceeds any of these three dimensions, it ceases to be a letter, and a mail piece which is not a letter cannot be a nonstandard letter. If an one-ounce-and-under piece exceeds any of these three dimensions (but does not exceed any of the maximum dimensions of a flat), it is a nonstandard flat subject to the surcharge.¹²

Therefore, the **aspect ratio** is the **only** criterion of First-Class nonstandard mail, as set out in the DMM and quoted above, which distinguishes between letters and nonstandard letters. Neither length, nor height, nor thickness distinguishes letters from nonstandard letters. If an one-ounce-and-under piece does not exceed any of the letter dimensions (6 1/8 inches high by 11½ inches long and 1/4 inch thick), and if the aspect ratio is more than 1.3 or less than 2.5, it is a standard letter. A nonstandard letter is a piece which has an aspect ratio of less than 1.3 and is considered “**too high**” to be a

¹² The distinction between letters and nonstandard letters is highly significant. Witness Sheehan misunderstands this distinction, believing that under-one-ounce nonstandard flats are really nonstandard letters. Since those one-ounce-and-under flats (which he misunderstands to be “nonstandard letters”) could not run on letter machinery, he concludes that the nonstandard surcharge is justified. In reality, flats are never be intended to run on letter machinery, irrespective of their weight. See discussion on witness Sheehan’s rebuttal testimony, *infra*.

standard letter, or a piece which have an aspect ratio of more than 2.5 and is considered “too long” to be a standard letter. (*See* NDMS-XE-1, Tr. 33/17422-23.)

A nonstandard surcharge based on letter aspect ratios can be justified only if there are demonstrable additional costs of handling such letters.

2. Flats

Flat-size mail is defined in the Domestic Mail Manual. (C050.3.0)

Flat-size mail other than in 3.2 [relating to Automation] is...:

- a. More than 11½ inches long, or more than 6 1/8 inches high, or more than 1/4 inch thick.
- b. Not more than 15 inches long, 12 inches high, and 3/4 inch thick.
- c. Unwrapped, sleeved, wrapped, or enveloped.

A flat must exceed at least one of the letter-size maximum dimensions. The categories of letter and flat are mutually exclusive. The minimum dimensions of a flat are the same as the maximum dimensions of a letter. A nonstandard flat subject to the surcharge is any flat which weighs one ounce or less. Such light-weight flats are often referred to as “flimsies.” It could be said that “**thinness**” is the defining characteristic of a nonstandard flat. (Tr. 33/17405, l. 8-11.) The First-Class nonstandard criterion dealing with aspect ratio has no relevance to nonstandard flats. (*Id.*, ll. 8-19.)

A nonstandard surcharge based on flats being too thin (flimsy) can be justified only if there are demonstrable additional costs of handling nonstandard flats.

3. Parcels

The Domestic Mail Manual provides definitions of “machinable parcel,” “irregular parcel,” and “outside parcel.” None of these definitions has much meaning

in understanding First-Class nonstandard parcels. Few, if any, mailpieces exceed the dimensions of 15 inches long, or 12 inches high (the maximum dimensions of a flat) and still weigh one ounce or less. Accordingly, a First-Class nonstandard parcel is generally a letter-shaped piece which is more than 3/4 inch thick. It could be said that “**thickness**” is the defining characteristic of a nonstandard parcel. Many of these nonstandard parcels are the typical incoming order to NDMS consisting of an exposed roll of film in a letter-sized envelope, which is under one ounce in weight, and exceeds 3/4 inch in thickness. *See* NDMS-T-1, p. 5, Tr. 24/12878, ll. 12-18. Film orders sent to NDMS are picked up or delivered in bulk, and therefore do not incur any carrier costs. (Tr. 24/12879, ll. 5-6)

A nonstandard surcharge based on parcels being too thick can be justified only if there are demonstrable additional costs of handling such parcels.

B. History of the First-Class Nonstandard Surcharge and the Need for Its Reassessment

The First-Class nonstandard surcharge has been a part of the DMCS since the mid-1970s. It became part of the classification schedule in 1976 following the decision in Docket No. MC73-1, although the surcharge was not actually implemented at that time. A surcharge has been imposed on nonstandard First-Class Mail since 1979 when the Commission’s recommended decision in Docket No. R78-1 was implemented.

The Commission determined that “mechanization requires that some definition of maximum size be specified for purposes of machine design and procurement.” The Commission also noted that oversized pieces “can be handled without detriment to

machines or other mail because they can be culled from the mailstream, but the cost of handling is greater.” The surcharge was intended to encourage the use of standard size mailpieces, and was expected to reduce postal costs, increase postal revenues, reduce cross-subsidization within the affected classes, and result in “swifter service.” *Op. & Rec. Dec.*, Docket No. MC73-1, pp. 25-29.

The Commission found that the unit cost differential between mechanically processed and manually processed letters was not an appropriate proxy for the costs incurred by the Postal Service in handling nonstandard letters, because the Commission’s classification of “poor aspect ratio letters” as nonstandard in Docket No. MC73-1 did not reflect the fact that such letters are manually processed, but rather the fact that poor aspect ratio letters “malprocessed” more often than standard letters. *Op. & Rec. Dec.*, Docket No. R78-1, p. 35.

The Commission rejected the Postal Service’s requested surcharge of 13 cents, recommending instead a surcharge of 7 cents. The Commission chose to adopt a uniform surcharge rate for letters, flats, and parcels based on reasons of rate simplicity and administrative convenience.

In Docket No. R80-1, the Commission increased the nonstandard single-piece surcharge from 7 cents per piece to 9 cents per piece. In Docket No. R84-1, the Commission increased the surcharge to 10 cents. In Docket No. R87-1, the Commission recommended that the single-piece surcharge remain at 10 cents, but instituted a 5 cent surcharge for nonstandard presort mail. In Docket No. R90-1, the surcharges were continued without change. In Docket No. R94-1, the Commission

recommended the Postal Service's request an increase in the nonpresort surcharge from 10 to 11 cents, but recommended no increase in the presort surcharge.

The nonstandard surcharge was recommended by the Commission and adopted by the Board of Governors during an earlier era, before automation, and even before modern mechanization, when there apparently was some justification for a surcharge due to operational limitations of existing equipment.

Since 1979, the foundational issue as to how this mail is actually handled and what additional costs, if any, are incurred by such mail, does not appear to have been examined critically. Mailpieces subject to the surcharge, especially letters and flats, are handled very differently in 1997 than when the Postal Service's request for a surcharge was filed in Docket No. MC73-1.

In this docket, for the first time in a generation, the operational and cost issues have been examined. They are analyzed in four separate pieces of testimony — witness Fronk (USPS-T-32), witness Daniel (USPS-ST-43), witness Haldi (NDMS-T-1), and witness Sheehan (USPS-RT-16) — and three relevant library references have been filed (USPS-LR-H-112, NDMS-LR-1, and NDMS-LR-2).

According to Dr. Haldi:

[a] number of important concerns raised initially by the Postal Rate Commission in Docket No. R78-1 have lain dormant for nearly 20 years — not because they are unimportant, or have ever been resolved, but because neither the Postal Service nor any organized group of mailers has invested the time and resources required to examine either the assumptions undergirding the surcharge or the methodology used to estimate costs. [NDMS-T-1, p. 3, Tr. 24/12876, ll. 5-10.]

Accordingly, Dr. Haldi recommends that the issue of the surcharge should be revisited in its entirety. Neither of the two original Postal Service witnesses (*i.e.*, witnesses Fronk and Daniel) advocating the proposed surcharge mentioned the need for any further study, but the Postal Service's rebuttal witness Sheehan did. *See* USPS-RT-16, p. 12, ll. 24-27, Tr. 33/17378. Witness Sheehan amplified his view on cross-examination that the question of automatability of First-Class letters should be addressed "fully." (Tr. 33/17421, ll. 2-7). NDMS submit that this further study has already occurred in this docket as a result of the attention given the issue by four witnesses, and that the justification for the First-Class nonstandard surcharge, having now been evaluated, has been found to be wanting.

C. The Postal Service's Case-in-Chief Contains No Evidence of a Valid Reason for Increasing the Surcharge or Even for Continuing the Surcharge

The only testimony originally filed by the Postal Service in support of the First-Class nonstandard surcharge was that of witness Fronk, the Postal Service's First-Class rate design witness. Witness Fronk could be said to have set new standards for brevity in making his proposal for the First-Class nonstandard surcharge. His testimony employed only 82 words to both propose and provide the Postal Service's complete justification for increasing the First-Class nonstandard surcharge for nonpresort mail by 45 percent, and for presort mail by 55 percent:

d. Nonstandard Surcharge

The Postal Service proposes increasing the nonstandard surcharge for nonpresort mail weighing one ounce or less from 11 cents to 16 cents. In addition, the Postal Service proposes increasing the

nonstandard surcharge for presort mail weighing one ounce or less from 5 cents to 11 cents.

These increases reflect the results of new nonstandard surcharge cost data (see USPS Library Reference H-112). The proposed surcharges are the minimums needed to recover the additional mail processing costs associated with handling nonstandard mail. [USPS-T-32, p. 24, ll. 4-12.]

During discovery, witness Fronk was asked whether he or any other Postal Service witness was sponsoring Library Reference H-112. He stated that none were, to his knowledge. (NDMS/USPS-T32-1, Tr. 4/1493.) Insofar as unsponsored library references are not record evidence under the rules, NDMS filed a motion to strike the testimony of witness Fronk. On August 18, 1997, LR-H-112 was revised to incorporate more recent data on the shape of First-Class Nonstandard Mail. On September 17, 1997, this NDMS motion to strike was denied in Presiding Officer's Ruling No. R97-1/20, and the Postal Service was given an opportunity to supplement the record within a week.¹³ This ruling was not complied with, but on September 29, 1997, 12 days later, the Postal Service filed USPS-ST-43, the Supplemental Testimony of witness Daniel, USPS-ST-43, to supersede and replace LR-H-112.

Witness Daniel adopted certain of witness Fronk's interrogatory responses, and certain of the Postal Service's institutional responses, and appeared for cross-examination on December 1, 1997. Where LR-H-112 contained no commentary as to limitations in the methodology that it employed, witness Daniel's testimony admitted

¹³ Additionally, witness Fronk supplemented his response to NDMS/USPS-T32-1 on September 9, 1997, to reflect that "The library reference was prepared by analysts in Cost Studies within Product Finance. The analyst with principal responsibility for the library reference was Sharon Daniel." (Tr. 4/1493.)

some of the limitations inherent in its costing methodology. (Tr. 14/7423, l. 16 through 7424, l. 1.) Most significantly, witness Daniel states that **“one limitation of the analysis presented here is our inability to determine the cost differences of just one-ounce non-standard pieces.”** (Emphasis added.) This is no small caveat. It reveals that the Postal Service’s only cost study, which it offered in this docket to support a 45 percent increase in the First-Class nonstandard surcharge, does not actually measure the cost of handling the pieces sought to be surcharged. It makes certain assumptions about mail processing costs, using proxies, and based on those assumptions it calculates a per-piece amount for the surcharge, without any direct measurement whatsoever of the actual cost of handling the one-once-and-under mail pieces which are subject to the surcharge.

In order to respond to interrogatories filed in this docket, witness Daniel found that she was required to modify certain of the data in the library reference. First, she corrected certain numbers in LR-H-112 which were based on using the wrong numbers from LR-H-106, which resulted in a reduction of the unit cost estimate for nonstandard pieces to under 15 cents. Witness Fronk later testified that if he had those revised costs he would have sought a 15 cent surcharge, rather than the 16 cent surcharge he suggested in his testimony. (Tr. 4/1634, ll. 23-25.) Second, she modified the relative mix of nonstandard pieces. The data that had been relied on in LR-H-112 were originally described as having a source in Docket No. R90-1, but this was inaccurate. (Tr. 14/7432, ll. 2-4.) These data originated from Docket No. R78-1 which may have

used data which **antedated the creation of the U.S. Postal Service.** (Tr. 14/7429, l. 14 through 7430, l. 14.)

When asked “To your knowledge, have you or anyone else in the Postal Service re-examined the capabilities of Postal Service mechanization or automation to handle nonstandard pieces as it might have changed since the ‘70s,” witness Daniel candidly responded: “No.” (Tr. 14/7448, ll. 12-16.)¹⁴

Witness Daniel added “It was my understanding that the definitions in the DMM apply to the machinability of the piece and that the machines were designed to handle pieces to find a standard and not designed to handle the nonstandard size pieces.”

When asked “So it was your understanding that in perhaps 20 years there had been no operational change in the dimensions of what would be considered a nonstandard piece?” witness Daniel responded “Exactly. It’s my understanding that the definition has been constant and they designed the machines around the specification.” (Tr. 14/7448, ll. 16-20.)

Stated another way, witness Daniel assumed that for 20 years letter machinery was designed by Postal Service engineers *not* to process “poor” aspect ratio letters, and flat sorting machines were designed *not* to handle flimsies. These assumptions are false, as demonstrated *infra*.

¹⁴ Witness Daniel recognized that the Commission criticized the Postal Service in Docket No. R78-1 for “not having studied the degree to which [nonstandard] letters are malprocessed” (Tr. 14/7455, ll. 18-22).

Lastly, witness Daniel testified that, with respect to letters, she was “assuming, in fact...that 100 percent of [nonstandard] letters are culled and manually processed.” (Tr. 14/7456, ll. 17-19.)

With respect to flats, witness Daniel’s proxy for one-ounce-and-under flats (with an average weight of 0.8 ounces, Tr. 19-B/8897) was an average flat which weighed 3.3 ounces. (Tr. 14/7473, ll. 22-24.) With respect to parcels, witness Daniel’s proxy for one-ounce-and-under parcels (with an average weight of 0.49 ounces¹⁵) was an average parcel which weighed 4.3 ounces. (Tr. 14/7473, l. 25—7474, l. 2.) The use of these proxies assumes that weight has no effect whatsoever on processing costs for flats over the range of 0.8 ounces to 3.3 ounces, and that weight has no effect whatsoever on processing costs for parcels over the range from 0.49 ounces to 4.3 ounces. This assumption is wholly inconsistent with the Postal Service charging a 23 cent additional ounce First-Class rate.

Witness Daniel’s testimony is based on these assumptions, and it is on the validity of these foundations that the First-Class nonstandard surcharge must rise or fall. If the only evidence before the Commission on this issue were the testimony of witnesses Fronk and Daniel, consisting principally of admissions of what the Postal Service does not know about the costs of First-Class nonstandard mail and its unsupported assumptions about processing methods, the First-Class nonstandard

¹⁵ If Postal Service data are accurate, the average nonstandard parcel (at 0.49 ounces) has a lower weight than the average nonstandard letter (0.65 ounces), or average nonstandard flat (0.8 ounces). Tr. 19-B/8897.

surcharge could not possibly be justified. Furthermore, subsequent direct testimony by Dr. Haldi and rebuttal testimony by Postal Service witness Sheehan demonstrate persuasively that the First-Class nonstandard surcharge should be terminated or drastically reduced.

D. Dr. Haldi Demonstrates that Postal Service Mail Processing Has Advanced to the Point where the First-Class Nonstandard Surcharge is No Longer Needed

Dr. Haldi testified that letter sorting has advanced significantly from where it had been in Docket No. R78-1. Dr. Haldi discussed the Advanced-Facer Canceler System (AFCS), Optical Character Readers (OCRs) that read typed addresses, print barcodes and sort letters, and a variety of barcode sorters that are now routinely used.

Dr. Haldi conducted an experiment of nonstandard letters using Christmas cards whose envelopes were 5 inches square, and therefore clearly nonstandard, with a 1.0 aspect ratio. The pieces were mailed from various locations in New York City and Chicago. (These letters have been submitted as LR-NDMS-1.) All cards received were barcoded, which Dr. Haldi stated “evidenced machine processing.” (NDMS-T-1, p. 12, Tr. 24/12885, l. 1.) Dr. Haldi concludes, “[o]n the basis of this small sample, witness Daniel cannot be right when she states that ‘they [nonstandard letters] would all be manually sorted.’ [Tr. 14/7471, l. 4.] (Emphasis added.) *Id.*, p. 12, ll. 3-5. Witness Sheehan, in his rebuttal testimony, stated he had reviewed the cards in the library reference, and that one card had two “ID tags” applied to the back, one horizontally and one vertically, indicating that the square card tumbled during

processing. "The remaining cards show no evidence of processing problems."

Witness Sheehan conceded that "[w]itness Haldi's anecdotal evidence does suggest that the Postal Service might want to re-evaluate the automatability of pieces with low aspect ratios " (USPS-RT-16, p. 12, Tr. 33/17378, ll. 15-27.)

Dr. Haldi explained that the average weight of a nonstandard flat was 0.8 ounces relying on Postal Service data and (Tr. 19-B/8897) that the specifications of the FSM 1000 demonstrate that it can handle flats weighing as little as 0.32 ounces.¹⁶ There were no standard size flat envelopes which had an empty weight of less than (a rounded) 0.4 ounces, according to an examination of envelopes offered for sale at office product retailers described by Dr. Haldi. (*See* LR-NDMS-2.) The FSM 881 has no stated minimum weight specifications, and there is no evidence that in testing that malprocessed pieces on these machines were flimsies. Flimsies should be no problem for the "new" or "next" generation flat sorting machines either. (NDMS-T-1, p. 13, l. 1 through p. 14, l. 12, Tr. 24/12886-87. First-Class (sealed against inspection) flats are virtually always contained in envelopes, (unlike Standard A circulars which would appear to be much more difficult to process), and therefore, one-ounce-and-under First-Class flimsies appear to be no problem for the modern flat sorting machines.

¹⁶ It is clearly an error to state, as has witness Daniel, that the FSM 1000 was purposely designed not to handle flimsies.

E. Witness Sheehan Demonstrates that the First-Class Nonstandard Surcharge is No Longer Needed

Witness Sheehan submitted rebuttal testimony asserting that “The Nonstandard Surcharge is imperative to Achieving our Automation Goals.” (USPS-RT-16.) This testimony asserts, as did witness Daniel, that the Postal Service’s letter “equipment and any new equipment requirements are based on the current DMM nonstandard mail piece definition” and therefore this definition is not obsolete. (USPS-RT-16, p.10, Tr. 33/17376, ll. 20-23.) On its face, this appears to be a strong endorsement for continuing the definition of a nonstandard letter. Witness Sheehan demonstrated conclusively, however, that his concern was not the definition of a nonstandard letter, but rather the definition of a letter. He points out, accurately, that if mailpieces which exceed the length, height and thickness dimensions of a nonstandard piece are run on letter machinery, the result is jams, machine damage, etc. This is undoubtedly true. But witness Sheehan, even during his cross-examination, never seemed to comprehend that mailpieces which exceed the length, height, and thickness dimensions of nonstandard pieces thereby exceed the identical length, height, and thickness dimensions for letters. That is, by definition such pieces are flats, or possibly parcels. He adhered to his erroneous view that a piece which exceeded these length, height, or thickness dimensions was a nonstandard letter, despite his agreement that it was not a letter. Obviously, there can be no such thing as a nonstandard letter which is not a letter. Therefore, witness Sheehan’s testimony must be read as demonstrating only that if one attempts to run nonletters (flats and parcels) on letter machinery, the machines do

not process them well. NDMS would concede this point. The point, however, is totally irrelevant to determining whether the nonstandard surcharge is “imperative” to the Postal Service achieving its automation goals. In no instance has witness Haldi suggested any changes in the definition of a letter.

Toward the end of his testimony, witness Sheehan actually seemed to grasp the point where he states: “[p]ieces that are over the height, length or thickness maximums are considered flats or parcels, not only for mail processing but also for delivery purposes.” (USPS-RT-16, p. 12, Tr. 33/17378, ll. 9-11.)

The “poor” aspect ratios therefore constitute the only distinction between letters and nonstandard letters. How these “poor” aspect ratio letters are handled thus becomes very significant. During cross-examination, witness Sheehan was asked questions concerning the automated handling of letters which had “poor” aspect ratio, and was shown a “Letter-Size Mail Dimensional Standards Template” with three aspect ratios marked on it. Area A marked the dimensions of letters that were nonstandard because they were “too high”; Area B was for letters that were nonstandard because they were “too long”; and Area C was for letters that were standard.

With respect to letters that were in Area A (“too high”), as discussed *supra*, witness Sheehan stated in his testimony that based on witness Haldi’s experiment with Christmas cards and the fact that they were processed on automation with no problems (other than one card “tumbling”), “the Postal Service might want to re-evaluate the automatability of pieces with low aspect ratios [*i.e.*, letters that are too high].” (*Id.*, p.

12, Tr. 33/17378, ll. 23-24.) He stated that the only problem that he could identify was the possibility of letters tumbling.

With respect to letters that were in Area B ("too long"), witness Sheehan stated that all of these letters would run without problems on all letter machinery, including the AFCS, OCR, DBCS, CSBCS, and LMLM. (Tr. 33/17417, l. 11 through 17419, l. 22.) Witness Sheehan could identify no operational justification whatsoever for imposing a nonstandard surcharge on these "too long" letters.

With respect to flats, witness Sheehan stated that he had no disagreement with the explanation, in the Postal Service's 1997 Comprehensive Statement on Postal Operations, that flimsies and other types of pieces were now machinable on the FSM 1000:

[A]pproximately 30 percent of the mail stream is flat mail or about 50 billion pieces annually fall into the "flats" category. Until now, about 25 percent of the flat mail could not be processed on existing flat-sorting equipment. Problems with stiffness, wrapping (poly), newspapers, **flimsies**, etc. contributed to this performance. These *nonmachineable flats required manual processing*.

An important addition to the automation/distribution capability is the FSM 1000. **This machine, with its channel transport, processes virtually all of the previously nonmachineable flats.** [Tr. 33/17401, ll. 2-17. *See* 1997 Comprehensive on Postal Operations, p. 49 (emphasis added).]

Witness Sheehan could only point out that the term used in the Comprehensive Statement was "virtually all" rather than "all."

With respect to thick letter-shaped pieces, Commissioner LeBlanc asked witness Sheehan to clarify the essential point that he had made, that these pieces would be processed as manual letters. Commissioner LeBlanc described a letter-shaped piece

“greater than a quarter of an inch” that was “kind of a fat thing.” Witness Sheehan stated such a piece “would not go through the automation pieces of equipment that I have in my testimony, but physically, it would be processed as a letter.” A piece processed as a letter without automation is processed as a manual letter. This testimony is highly significant regarding the cost proxies that should be used by the Postal Service in developing a nonstandard surcharge, if any, discussed *infra*. (Tr. 33/17434, l. 4 through 17435, l. 3.)

F. First-Class Nonstandard Volumes and Revenues Do Not Justify the Existence of a Surcharge

Dr. Haldi explained his view as to why the volumes and revenues generated by the existence of First-Class nonstandard mail are insufficient to justify continuation of the surcharge. The 1996 volume of First-Class nonstandard mail was estimated to be 383 million¹⁷ pieces, of which 85 percent (326 million) was single-piece mail and the remainder was presort. The surcharge raised \$35 million in 1996, with \$32 million coming from single-piece mail users. (NDMS-T-1, p. 22, Tr. 24/12895.)

The 326 million pieces of nonstandard single-piece mail were 0.60 percent of all First-Class single-piece volume, and only 0.15 percent of First-Class single-piece

¹⁷ Although the Postal Service estimates that 90.4 percent of the nonstandard single-piece mail pays the surcharge, Dr. Haldi found this number optimistic, due to the fact that the surcharge was not imposed on any of the Christmas cards in his sample mailing (LR-NDMS-1). Moreover, the surcharge is not easy to apply. Trained data collection personnel do not recognize the pieces, according to the Postal Service. Even witness Daniel could not recall the dimensions or precise aspect ratios which define nonstandard pieces without looking at the written definition or a template. (Tr. 14/7435, l. 16 through 7436, l. 10.)

revenue. First-Class nonstandard presort revenues were only 0.03 percent of total revenues. (*Id.*)

Serious policy reasons militate against having such a surcharge for small subsets within First-Class Mail.

The Commission should give serious consideration to the advisability of maintaining any rate category that constitutes well under 1 percent of volume — and one-tenth of 1 percent of revenue — of First-Class Mail. If the Commission were to affirm the surcharge, this precedent could be used to justify almost limitless “balkanization” of First-Class Mail. Moreover, it could open the door to doing so in a seemingly arbitrary fashion.... [NDMS-T-1, p. 42, Tr. 24/12915.]

The very small volumes subject to the nonstandard surcharge should be viewed in context. In this docket, witness Fronk proposes elimination of the First-Class presort heavy-weight discount, which applies to some 300 million pieces. Witness Fronk argues that this volume is not sufficient to warrant separate treatment, and that simplification of the rate structure would be preferable. If these reasons are considered compelling for First-Class presort mail, they should have even greater effect with respect to First-Class single-piece mail, the one subclass used most heavily used by the least sophisticated mailers.

Dr. Haldi identified the underlying policy issue as follows:

Cost-driven de-averaging can be applied to distinguish any subsegment of mail whose average processing cost differs significantly from the average processing cost of the segment as a whole, supporting the creation of additional rate categories. Of course, the quest for more cost-based rates can justify any and all de-averaging, however wise or foolish it may be.

The key issue is: under what conditions should rate categories be created and such de-averaging built into the rate structure? [NDMS-T-1, p. 36, ll. 4-11, Tr. 24/12909.]

Section 3622(b) of the Act sets out nine criteria for rate changes. Section 3622(b)(7), “simplicity of structure for the entire schedule and simple, identifiable relationships between the rate or fees charged the various classes of mail for postal services,” should militate against continuation of this surcharge.

Section 3623(c) of the Act sets forth six criteria for changes to the Domestic Mail Classification Schedule, but only the first criterion is particularly relevant: establishment of a fair and equitable classification system for all mail. The Postal Service’s *ad hoc* imposition of surcharges which are frequently not paid by some mailers does not appear to meet this standard.

As a matter of equity, revenues from First-Class flats, as a group, and First-Class parcels, as a group, greatly exceed their respective costs. This is because the fee charged for extra ounces (currently and proposed to remain at 23 cents per ounce, which equals \$3.68 per pound) appears to be much greater than the cost of handling extra weight (NDMS-T-1, p. 33, Tr. 24/12906).¹⁸ These arguably excessive fees are often paid by the same mailers who must pay the extra fee for light-weight nonstandard flats and parcels. Since the extra-ounce fee is high, there is a strong argument for

¹⁸ Although witness Daniel resisted agreeing with such a proposition, on the theory that nonstandard pieces also had certain delivery costs, she ultimately agreed that the revenue from such pieces exceed their costs. Tr. 14/7475, ll. 13-14.

allowing one-ounce-and-under pieces to be rate-averaged with similar pieces that weigh more than one ounce.

This case must be decided on the evidence of this record, of course, and the Postal Service should not benefit from its lack of long-overdue studies and inattention to the matter. The current equipment in use by the Postal Service has rendered the 25-year-old nonstandard mail criteria almost meaningless. Efficiency in postal operations would be promoted by eliminating this distinction without a difference. The mailing public would greatly benefit from such a simplification of the classification schedule.

Elimination of the nonstandard First-Class mail classification is desirable because it would do away with an obscure, unpublicized requirement that impedes the efficient processing of Aunt Minnie's mail. Its elimination is justified because the Postal Service both admits it is unable to isolate and identify the costs incurred by nonstandard First-Class mailpieces, and the evidence in this record indicates that almost all nonstandard mailpieces do not present the problems to the Postal Service once thought.

G. In the Alternative, the Amount of the Current First-Class Nonstandard Surcharge Should Be Reduced

The Postal Service's Request, insofar as it seeks to increase the current First-Class nonstandard surcharge from 11 cents to 16 cents, lacks credible support in the record. It relies upon cost data which have no proven relationship with the actual costs incurred by the First-Class nonstandard pieces sought to be surcharged, and it makes

certain assumptions concerning the processing of nonstandard mailpieces that are rebutted by the evidence in this proceeding.

Nevertheless, if the Commission does not choose to eliminate the surcharge at this time, NDMS would urge the Commission, in accordance with Dr. Haldi's recommendation, to reject any increase in the current surcharge and instead to decrease the current surcharge (presort and single-piece) to a maximum of 4 or 5 cents. Such a rate would be based on the only proxy that has any theoretical validity, the difference between manually processed letters (20.54 cents) and the average cost of First-Class letters (11.74 cents). *See* NDMS-T-1, pp. 45-47, Tr. 24/12918-20. At that, the proxy has more applicability to the cost of handling nonstandard parcels (according to witness Sheehan's response to Commissioner LeBlanc's question, Tr. 33/17434, ll. 4-21), than nonstandard ("poor" aspect ratio), for which it was designed.

If the Commission were able to derive such evidence from the record, a reduced surcharge reflecting the difference between the verifiable average costs of First-Class letters and manually processed letters (8.8 cents), together with a reasonable (50 percent) passthrough, would be the most that could be considered consistent and fair under the circumstances of this case. NDMS-T-1, pp. 46-47, Tr. 24/12919-20.

The reasonableness of Dr. Haldi's estimate of the "maximum" possible nonstandard surcharge, based upon the evidence, can be tested by reference to the Postal Service's own evidence in this proceeding.

The Postal Service based the proposed surcharge on a weighted (by volume) average of the purported cost differences between processing various under-one-ounce

nonstandard mailpieces and the cost of processing an “average” letter (11.74 cents). Because the Postal Service lacks data reflecting the processing costs of one-ounce-and-under nonstandard mail pieces, it uses cost proxies. The Postal Service has determined the processing cost of a manually-processed letter, an “average” flat (weighing 3.3 ounces) and an “average” parcel (weighing 4.3 ounces). It compares these three numbers to the 11.74 cent cost of processing the “average” letter. Table 1 illustrates this calculation, and the resulting supposed cost differentials for single pieces:

TABLE 1
FIRST-CLASS NONSTANDARD PIECES
POSTAL SERVICE CALCULATION OF COST DIFFERENTIAL

Letters:	20.54 cent Manual Letter Cost less 11.74 cent Average Letter Cost = 8.8 cents
Flats:	32.66 cent Average (3.3 Ounce) Flat Cost less 11.74 cent Average Letter Cost = 20.6 cents
Parcels:	74.57 cent Average (4.3 Ounce) Parcel Cost less 11.74 cent Average Letter Cost = 62.3 cents

Once the Postal Service calculated these hypothetical cost differentials, it developed a mail mix by shape for First-Class nonstandard mail, as set out in Table 2.

TABLE 2

**FIRST-CLASS NONSTANDARD PIECES
POSTAL SERVICE VOLUME ESTIMATES BY SHAPE
(Revised Shape Mix, updating Docket No. MC73-1 data)**

Shape	Volume (Millions)	Percentage
Letters:	62.7	19.3%
Flats:	238.0	73.1%
Parcels:	24.9	7.6%
Totals:	325.6	100.0%

Finally, the Postal Service arrived at its weighted cost differential by applying the above percentages to the cost differential relating to each corresponding nonstandard mailpiece shape to arrive at a contribution to the weighted surcharge of each nonstandard mailpiece type. This calculation is illustrated in Table 3.

TABLE 3

FIRST-CLASS NONSTANDARD PIECES
POSTAL SERVICE FORMULA
TO DETERMINE WEIGHTED COST DIFFERENTIAL

Letters: 19.3% x 8.8 cents	= \$0.0169
Flats: 73.1% x 20.6 cents	= 0.1512
Parcels: 7.6% x 62.3 cents	= <u>0.0477</u>
WEIGHTED COST DIFFERENTIAL:	\$0.2158 ¹⁹

Of course, these cost proxies were offered by witness Daniel based on her assumptions. As the record has developed, the basis for the use of these cost proxies has been refuted not only by the testimony presented by Dr. Haldi, but also by witness Sheehan.

NDMS submit that, even using the methodology and formulaic approach of the Postal Service in calculating the surcharge, Dr. Haldi's recommendation that the letter proxy alone be used for all shape nonstandard pieces is the most reasonable assumption that can be made on this record.

Witness Sheehan agreed that there are no "poor" aspect ratios which are "too long" (Area B of the template) which cannot be handled on letter machines. Although some letters that are "too high" (Area A of the template) might tumble, the percentage

¹⁹ The source of Tables 1, 2, and 3, and for the restatement of the Postal Service's methodology, is Exhibit USPS-43C, and the accompanying testimony of witness Daniel (USPS-T-43), as modified by witness Daniel's response to NDMS/USPS-ST43-18, Tr. 14/7400-7402.

clearly is small. For example, witness Sheehan confirmed that all of the letters (which were outside the permitted aspect ratio) used in Dr. Haldi's experiment (LR-NDMS-1) were processed by automation, and only one tumbled. *See* cross-examination of witness Sheehan, Tr. 33/17413, 17419-20.

With respect to flats, witness Sheehan agrees that nonstandard flats clearly are machinable on the FSM 1000. The Postal Service's own documents confirm that fact. *See* USPS-LR-H-169, p. 1 (indicating that flats, one-ounce-and-under, known as "flimsies," are well within the limitations of the FSM 1000). *See also* Postal Service responses to NDMS/USPS-T26-3, 4, and 10 (Tr. 19-B/8930-31, 8937-38). As Dr. Haldi pointed out, flats of one-tenth of an ounce were within the specifications for the FSM 1000 tested in the Albany, New York in 1992, and all known standard size flat envelopes appear to be within the weight specifications of the FSM 1000. NDMS-T-1, p. 12, l. 9 through p. 13, l. 5, Tr. 24/12885-86. Even witness Sheehan, the Postal Service's rebuttal witness, admitted that he had no reason to disagree with the statement, in the Postal Service's 1997 Comprehensive Statement on Postal Operations, that the FSM 1000 "with its channel transport, processes virtually all of the previously nonmachinable flats." Tr. 33/17401. The evidence is less clear with respect to processing flats on the FSM 881, but that machine has no stated minimum weight specifications, NDMS-T-1, p. 14, ll. 5-6, Tr. 24/12887, NDMS is aware of no evidence that indicates it is incapable of handling flimsies. If nonstandard flats have an additional cost, due to their "flimsy" nature, it would be amply covered by a surcharge based on the manual letter cost proxy.

Nor should the costs of parcels be included because, as witness Sheehan testified, lightweight (one-ounce-and-under) pieces within the height and length dimensions of letters, but which are too thick, are processed as letters. Tr. 33/17434, ll. 16-21. Moreover, many of these parcels are film cartridges which incur no carrier costs. Therefore, for these nonstandard parcels, the manual letter cost proxy would appear to be far more valid than use of the average parcel cost proxy.

Lastly, if the manual letter cost is used, Dr. Haldi has proposed that only one-half of the shape-related cost differential postulated be passed through in the form of surcharge. This would result in a surcharge of about 4.4 cents, rounded down to 4 cents, or up to 5 cents.

If one were to read the evidence in a light most favorable to the Postal Service, and assume liberally that the Postal Service has a potential additional cost problem with 25 percent of its poor aspect ratio nonstandard letters, 25 percent of its nonstandard flats (flimsies), and 100 percent of its nonstandard parcels, the following nonstandard additional handling cost would be developed.

TABLE 5

FIRST-CLASS NONSTANDARD PIECES
NDMS ADJUSTED POSTAL SERVICE FORMULA
TO DETERMINE WEIGHTED COST DIFFERENTIAL

Letters	$19.3\% \times 8.8 \text{ cents} = \$.0170 \times 25\% =$.00425
Flats	$73.1\% \times 8.8 \text{ cents} = \$.0643 \times 25\% =$.01601
Parcels	$7.6\% \times 8.8 \text{ cents} = \$.0067 \times 100\% =$	<u>.00669</u>
NDMS ADJUSTED WEIGHTED COST DIFFERENTIAL		.02695

Even with a 100 percent passthrough, this would produce a nonstandard surcharge of only two or three cents, which is even lower than the four-cent to five-cent surcharge that Dr. Haldi said (before witness Sheehan testified) could be considered reasonable.

Clearly, the adjustments reflected in Table 5 above have not been derived scientifically, but they are more valid in theory than the Postal Service's proposal, and since they are based on record evidence (while the Postal Service's assumptions appear to be contrary to the evidence), they deserve the Commission's serious consideration.

II. PRIORITY MAIL RATES SHOULD BE MODIFIED

A. The Maximum Weight of First-Class Mail Should Be Increased

Since the Commission's recommended rates in Docket No. R87-1 were implemented 10 years ago, the maximum weight for First-Class Mail has remained at 11 ounces, its historic low point. This maximum First-Class Mail weight is viewed as the breakpoint between First-Class Mail and Priority Mail. Maintaining a low, 11-ounce breakpoint, while adopting the Postal Service's proposed First-Class Mail and Priority Mail rates, would widen the gap between the maximum First-Class Mail rate and the minimum 2-pound (32 ounce) Priority Mail rate. This would cause two adverse effects on the rate structure. First, the wider the gap, the greater the pressure to reduce it by setting a lower-than-indicated minimum Priority Mail rate. Second, a wide rate gap confuses this relationship between First-Class Mail rates and Priority Mail rates. Since Priority Mail, in addition to being one of the Postal Service's expedited products, also functions as heavyweight First-Class Mail, the relationship between the rate structures of the two subclasses should be simple and easy to understand.

Accordingly, NDMS propose raising the maximum weight of First-Class Mail to 13 ounces, in order to rationalize the relationship between the First-Class Mail and Priority Mail rate schedules, and to promote the recommendation of a more appropriate minimum Priority Mail rate without having an unduly wide gap between First-Class Mail rates and Priority Mail rates.

It is instructive to review how the current 11-ounce breakpoint between First-Class Mail and Priority Mail originated. In Docket No. R87-1, the Commission's rates for First-Class Mail (\$0.25 for the first ounce, and \$0.20 for each additional ounce) and for Priority Mail (a 2-pound rate of \$2.40), with the 12-ounce maximum weight for First-Class Mail in effect at the time, would have led to the anomalous result of a maximum First-Class Mail rate \$0.05 greater than the minimum Priority Mail rate. *See Op. & Rec. Dec.*, Docket No. R87-1, p. 444. To avoid creating a "negative gap," the Commission recommended lowering the breakpoint between First-Class Mail and Priority Mail from 12 ounces to 11 ounces. The result was a much more coherent, positive gap of \$0.15 between the maximum First-Class Mail rate and the minimum Priority Mail rate. *Id.*

Today, instead of a too-narrow gap, the Commission is faced with the opposite problem. Since the rates recommended in Docket No. R87-1 were implemented, the minimum rate for Priority Mail has increased 25 percent while the 11-ounce maximum rate for First-Class Mail has increased only 16.4 percent, largely due to the fact that the additional ounce rate of First-Class Mail has not increased at all since Docket No. R90-1. These different rates of increase for the minimum Priority Mail rate and the maximum First-Class rate have widened the gap. It now stands at \$0.38, and would rise to \$0.57 under the Postal Service's proposed rates without any change in the breakpoint.²⁰ (*See Table 1.*)

²⁰ Postal Service Priority Mail rate design witness Sharkey stated that the "need to minimize the price gap between [the 2-pound Priority Mail rate] and 11-ounce

Table 1

**Current and Proposed
Rate Gap Between First-Class Mail and Priority Mail**

	First-Class Rate First Ounce/ Additional Ounces	Minimum Priority Mail Rate	Breakpoint	Gap
Current Rates and Breakpoint	\$0.32 / \$0.23	\$3.00	11 ounces	\$0.38
Postal Service Proposed Rates and Breakpoint	\$0.33 / \$0.23	\$3.20	11 ounces	\$0.57
NDMS Proposed Rates and Breakpoint	\$0.33 / \$0.23	\$3.30	13 ounces	\$0.21

To narrow the gap, the Commission has three options. It could (i) increase the rate on additional ounces of First-Class Mail by 3 to 5 cents, (ii) continue to reduce artificially the minimum Priority Mail rate below the indicated rate (and thus artificially drive up rates on zoned Priority Mail in an effort to meet the target revenue for the subclass), or (iii) return the maximum First-Class Mail weight to 13 ounces.²¹ NDMS

First-Class letter rate” was a factor in proposing a lower rate increase for the 2-pound Priority Mail rate. *See* response to NDMS/USPS-T33-5(b), Tr. 4/1950-51. Neither the Postal Service nor any intervenor other than NDMS has proposed any change to the breakpoint.

²¹ The maximum First-Class Mail rate was increased from 12 ounces to 13 ounces in Docket No. R74-1. *See Op. & Rec. Dec.*, Docket No. R74-1, p. 190, and Appendix 1, Schedule A-1.

submit that the third option would be least disruptive to the rates for both First-Class Mail and Priority Mail, and hence more desirable.²²

B. An Alternative Procedure for Priority Mail Volume and Revenue Projections Is Necessary

As part of a request for a rate change, under Section 54(j) of the Commission's rules of practice (39 C.F.R. section 3001.54(j)), the Postal Service is required to project the estimated volume and revenue for each class and subclass resulting from its suggested rates. (Section 54(j)(2).) The Postal Service is required to base these projections on detailed demand analyses (Section 54(j)(5)(i).) and to present revenue data "disaggregated to each unique rate element." (Section 54(j)(3).) In this docket, as in prior dockets, the Postal Service has used the *average* proposed rate increase for Priority Mail to estimate the effect of proposed rates on volume and revenue, even though its requested rate design for Priority Mail encompasses rates which vary widely from the average. See USPS witness Sharkey workpaper USPS-33M. NDMS submit that the Postal Service's method for projecting After Rates volumes fails to project with accuracy or reliability the volume and revenue effects of rate changes on the "unique rate elements" within a subclass. Moreover, as explained below, it is susceptible to highly anomalous results. Dr. Haldi proposes an alternative to this method which

²² NDMS has submitted a detailed volume study in support of its proposed 13-ounce breakpoint, set forth in Appendix A of NDMS-T-2, Tr. 20/10375-80. Dr. Haldi further explained his method for projecting the volume effects of a change to the breakpoint in response to POIR No. 17, Tr.32/17315-22.

allows volume and revenue to be projected accurately at the level of detail called for in Section 54(j).

1. The Postal Service's Method for Projecting Test Year After Rates Volumes for Priority Mail Ignores the Effects of Rate Design, Produces Misleading Forecasts, and Should Be Changed

The Postal Service's method for projecting Test Year After Rates volumes and revenues can produce misleading results.²³ As discussed in Dr. Haldi's testimony, using the subclass-wide average rate increase may be adequate if a rate change is uniform, as was the Postal Service's requested 10.3 percent across-the-board increase in Docket No. R94-1. But when individual rate changes vary widely, as in the Postal Service's current request, the Postal Service's methodology can project higher-than-expected volumes for "rate elements" with higher-than-average rate increases and lower-than-expected volumes for elements with below average increases (or even rate decreases). See NDMS-T-2, pp. 21-22, Tr. 20/10314-5.

The problems with using the Postal Service's methodology to project After Rates volumes originally were raised by Nashua and District in their motion to reconsider rates recommended by the Commission in Docket No. R94-1. See Nashua/District Photo *Memorandum in Support of Modification of Priority Mail Rates on Reconsideration by the Commission*, Docket No. R94-1, Appendix 1. In that docket, the Commission rejected the Postal Service's request for an across-the-board

²³ In addition, the Postal Service's estimates do not provide the level of detail apparently required by Section 54(j).

Priority Mail rate increase in favor of smaller increases to unzoned Priority Mail (*e.g.*, a 3.4 percent increase to the 2-pound rate) and greater increases to much of zoned Priority Mail (including increases of more than 30 percent to some cells). After Rates volume projections based on the Commission's *average* proposed rate increase (7.4 percent) were somewhat greater in every rate cell than volume projections based on the Postal Service's proposed uniform rate increase (10.3 percent), even though: (i) in some cells, the Commission's rate increase was less than the average 7.4 percent, and even greater After Rates volumes would be expected, and (ii) in a wide range of other cells, the Commission's rate increase substantially exceeded 10.3 percent, hence smaller After Rates volumes than those projected by the Postal Service would be expected. *See* NDMS-T-2, pp. 21-22, Tr. 20/10314-15.

As pointed out by Nashua/District in Docket No. R94-1, use of the Postal Service's method to project After Rates volumes can produce results which defy common sense — higher rates which lead to higher-than-expected volumes in some rate cells and lower rates which lead to lower-than-expected volumes in other rate cells. In practice, this methodology has disguised the crippling effect that large rate increases have on zoned Priority Mail volume and market share.

2. Rate Cell Volume and Revenue Projections Under Dr. Haldi's Proposed Alternative Procedure Would Depend Upon Rate Design, as They Should

Dr. Haldi proposes a new, more accurate method for volume projections which corrects the obvious flaws in the Postal Service's method. In his testimony, NDMS-T-

2, Dr. Haldi uses (i) the subclass' own price elasticity of demand,²⁴ as provided by Postal Service witness Musgrave (USPS-T-8), and (ii) the proposed rate change for each rate cell (rather than the subclass average rate increase) to project After Rates volumes and revenues for each rate cell in Priority Mail. *See* NDMS-T-2, pp. 24-26, Tr. 20/10317-19. Dr. Haldi's proposed method not only better conforms to the requirement of Section 54(j) that volume and revenue projections be disaggregated, it also avoids totally incongruous results, and provides the Commission with a means to consider the effect of individual rate changes on volume and revenue.

C. The Postal Service Needs Better Cost-based and Competitive Priority Mail Rates

Priority Mail is a flagship Postal Service product. It needs rates which are cost-based and competitive for all weights and zones. These objectives can be accomplished in the following ways. First, distance-related transportation costs should not be marked up. Second, the hidden surcharge on zoned Priority Mail should be eliminated. Third, equal rate increments for each pound of unzoned Priority Mail should be retained. Fourth, the Priority Mail presort discount should be eliminated, as is also proposed by the Postal Service. Finally, Dr. Haldi supports the Postal Service's proposal for the

²⁴ Just as every Priority Mail rate does not necessarily increase by the same percentage, every rate cell may not have the same own-price elasticity. Cell-by-cell own price elasticities are unavailable, however. The Commission should use the most detailed rate and elasticity data available in order to improve the accuracy of the volume and revenue effects of proposed rates.

treatment of delivery confirmation, and opposes United Parcel Service's proposed Priority Mail parcel surcharge. Each proposal is discussed below.

1. Distance-Related Transportation Costs Should Not Be Marked up

A substantial mark-up on distance-related transportation costs has been built into the Postal Service's rate design for Priority Mail. This policy, *inter alia*, has resulted in Priority Mail rates which are uncompetitive in much of the market for zone-rated Priority Mail. NDMS propose rates which correct this flaw in the Postal Service's proposed rate structure for 6- to 70-pound Priority Mail.

In Docket No. R94-1, Nashua/District Photo witness Haldi proposed, *inter alia*, that Priority Mail distance-related transportation costs not be marked up, and instead be subject to a 100 percent passthrough. This approach would develop rates for Priority Mail consistent with the principle of "top-down" rate design, under which rates for entering mail closer to the final destination reflects a passthrough of the transportation cost differences. In Docket No. R94-1, the Commission seemed to agree that rates for heavyweight Priority Mail should be based on top-down rate design principles, but feared the effects on rates for close-in zones. Without record evidence isolating the effects of top-down rate design on rates for the close-in zones, the Commission rejected Nashua/District Photo's proposal. *See Op. & Rec. Dec.*, Docket No. R94-1, p. V-39.

In the current docket, Dr. Haldi has presented a more detailed proposal. This is largely because, unlike in Docket No. R94-1, the Postal Service has provided complete data regarding distance-related and non-distance-related Priority Mail costs. *See USPS*

witness Sharkey's workpaper USPS-33Q *and* NDMS-T-2, p. 30, Tr. 20/10323. As Dr. Haldi shows in his testimony, his proposal is highly beneficial to rates for close-in zones, and has only a minor per-piece effect on unzoned Priority Mail rates. NDMS-T-2, p. 32, Tr. 20/10325, and Table C-8, Tr. 20/10408. The possible adverse effect on rates to the close-in zones anticipated by the Commission in Docket No. R94-1 turns out to be groundless. Dr. Haldi's proposed rates are in fact highly beneficial for Priority Mail, and should be adopted.

2. The Hidden Surcharge on Zoned Priority Mail Should Be Eliminated

In Docket No. R94-1, the Postal Rate Commission recommended a lower-than-indicated rate of \$3.00 on unzoned two-pound-and-under Priority Mail and rates for three-to-five-pound unzoned Priority Mail at \$1.00 increments above that.²⁵ The lower-than-indicated \$3.00 rate was driven by two considerations: (1) narrowing the "gap" between the maximum First-Class rate and the minimum Priority Mail rate; and (2) achieving "easily understandable and simple" even-dollar rates for the 95 percent of Priority Mail volume that is unzoned. *Op. & Further Rec. Dec.*, Docket No. R94-1, p. 5. The Commission's recommended rates also shifted substantial revenue burden away from the high-volume, unzoned 2-pound-and-under rate cells to the low-volume, zoned 6- to 70-pound rate cells. In effect, the Commission imposed a surcharge on zoned

²⁵ The Postal Service also proposed a 2-pound-and-under Priority Mail rate of \$3.20 in Docket No. R94-1.

Priority Mail to pay for lower rates for unzoned (particularly 2-pound and flat-rate) Priority Mail.

The Commission's formula, outlined in PRC Library Reference 12 (PRC-LR-12), Docket No. R94-1, first determines a per-piece cost for all Priority Mail, as well as per-pound costs for each zone. The Commission divided the total attributable costs for Priority Mail (\$1,373,553,000) into three components: (i) non-transportation, non-weight-related costs, (ii) transportation costs, and (iii) non-transportation weight-related costs. The first component was used to determine the per-piece cost (irrespective of weight or zone). The second two components were used to calculate the pound cost for each zone. The Commission multiplied these costs by the contingency and mark-up to arrive at initial piece and pound rates. PRC-LR-12, Docket No. R94-1, pp. 1-4. (*See* Table 2.)

Table 2

**Docket No. R94-1
Initial Piece and Pound Rates**

Per Piece	Per Pound					
	L,1,2,3	Zone 4	Zone 5	Zone 6	Zone 7	Zone 8
\$2.207	\$0.4319	\$0.6497	\$0.7229	\$0.7906	\$0.8648	\$1.0528

First, the Commission determined the indicated zoned rates for 2-pound and flat-rate Priority Mail. The Commission averaged these pound and piece rates across all zones to arrive at an indicated rate of \$3.094. The Commission used this indicated

rate to calculate that setting a \$3.00 rate for 2-pound-and-under Priority Mail would cause a revenue shortfall of \$57.4 million.²⁶ *Id.*, p. 9.

Next, the Commission calculated new indicated rates for 3- to 5-pound Priority Mail, based on the original pound and piece rates plus the revenue shortfall for 2-pound Priority Mail of \$0.374 per 3- to 70-pound piece. These indicated rates, averaged by volume across all zones, were \$4.49 for 3-pound, \$5.18 for 4-pound, and \$5.87 for 5-pound Priority Mail. *Id.*, p. 10. By charging \$4.00, \$5.00 and \$6.00 for 3-, 4- and 5-pound Priority Mail, respectively, the Commission found an additional net shortfall of \$36 million, or \$0.925 per piece of 6- to 70-pound Priority Mail. Combining both the \$0.374 surcharge for all pieces between 3- and 70-pounds and the \$0.925 surcharge for all pieces between 6- and 70-pounds, the Commission imposed a total surcharge of \$1.295 on each piece of 6-pound-and-over zoned Priority Mail. This surcharge was added to the per-piece component of the indicated rates for 6- to 70-pound Priority Mail. *Id.*, pp. 9 to 11. (*See* Table 3.)

²⁶ Note that \$3.094 is merely the indicated rate. The actual rate likely would have been \$3.10, since Priority Mail rates are rounded to the nearest nickel. The revenue shortfall caused by charging \$3.00 for 2-pound Priority Mail rather than \$3.10 would have been \$60.9 million.

Table 3

Docket No. R94-1
Postal Rate Commission Priority Mail Rate Design

	Step 1	Step 2				Step 3
	2-pound	3-pound	4-pound	5-pound		
Initial Indicated Rate (\$)	3.094	4.118	4.805	5.494		
Recommended Rate (\$)	3.000	4.000	5.000	6.000		
Difference (\$)	-0.094	-0.118	0.195	0.506		
Revenue Effect (\$000)	57,394	7,839	-5,931	-8,867		
Effect (\$) per zoned piece	1.474	0.20	-0.15	-0.23		
						Revenue to be recovered by each piece of zoned 6-pound-and-over Priority Mail: 1.295

Source: PRC Lib. Ref. 12, Docket No. R94-1, pp. 9-10 Indicated rates are the initial indicated rates from PRC-LR-12 and Table 2, *supra*.

In the current docket, the Postal Service's Priority Mail rate request is unfortunately not as detailed as the Commission's *Op. & Further Rec. Dec.* data in Docket No. R94-1. Priority Mail rate design witness Sharkey does not present detailed volume and weight data of the sort used by the Commission in PRC-LR-12 to calculate the average indicated rate for 2-pound-and-under Priority Mail. By witness Sharkey's

own admission, however, the Postal Service's proposed rate for 2-pound-and-under Priority Mail was not only based on "no explicit cost consideration" (*see* response to NDMS/USPS-T33-5, Tr. 4/1950-51), but his rate design method for Priority Mail also makes higher-than-indicated rates for 6- to 70-pound Priority Mail "a mathematical imperative."²⁷

Using the Postal Service's methodology, it appears that in the current docket, a \$3.25 minimum rate was indicated. Postal Service witness Tolley stated that \$3.25 was included in a "preliminary set of rates investigated prior to the Postal Service's filing of R97-1." *See* response to POIR No. 8 (11). Using volumes from workpaper USPS-33K and the average weights of flat-rate mailpieces by zone derived from Docket No. R94-1, PRC-LR-12, p. 8F, the revenue at indicated rates for minimum rate Priority Mail in this docket is \$2,413,808,854, which averages \$3.2453 per piece. If this were the indicated rate, it would be rounded to \$3.25, the same rate which appeared in LR-H-172 and which was cited in POIR No. 8(11). Thus, even under its own methodology, the Postal Service has again arbitrarily reduced the minimum Priority Mail rate below its own indicated rate, to the detriment of 3-pound-and-over Priority Mail. The Commission especially must avoid imposing any extra rate burden on the embattled zoned, 6 pound-and-over Priority Mail rates.

²⁷ NDMS/USPS-T33-6(b), Tr. 4/1952. Some of witness Sharkey's 6- to 70-pound Priority Mail rates are based on increments from the 5-pound rate; many others include an additional 20 percent mark-up to indicated rates (which already include the coverage factor and contingency). *See* response to UPS/USPS-T33-11(a), Tr. 4/1992-93.

3. Uniform Incremental Rates for 2- to 5- Pound Priority Mail Pieces Should Be Retained

In Docket No. R94-1, the Commission adopted Nashua/District Photo witness Haldi's proposal that the rates for 2- to 5-pound Priority Mail should be based on equal incremental pound rates, thus making "95 percent of Priority Mail volume... subject to rates which exemplify the standards of simplicity and ease of use." *Op. & Further Rec. Dec.*, Docket No. R94-1, p. 54. The Postal Service request in this docket changes this policy, with a proposed \$1.20 increment between the 2- and 3-pound unzoned rate, and \$1.10 increments between the 3- to 5-pound unzoned rates. NDMS propose equal \$1.10 increments between the unzoned 2- to 5-pound Priority Mail rates. The principle of even increments should be retained. Dr. Haldi has proposed rates which preserve the simplicity of uniform rate increments for unzoned Priority Mail, and they should be adopted. NDMS-T-2, p. 39, Tr. 20/10332.

4. Presort Discounts Should Be Eliminated

In this docket, Postal Service witness Sharkey has proposed eliminating the 11-cent per-piece discount on presorted Priority Mail. *See USPS-T-33*, p. 31. As discussed by Dr. Haldi at NDMS-T-2, p. 40, Tr. 20/10333, NDMS concur with the Postal Service's proposal to end the discount.

5. The Postal Service's Proposed Rates for Delivery Confirmation Should Be Adopted

In this docket, the Postal Service proposes a delivery confirmation service for Priority Mail, as well as certain subclasses of Standard B Mail (Parcel Post, Bound Printed Matter, Special Mail, and Library Mail). For Priority Mail, two separate services are proposed: Priority Mail Base Delivery Confirmation (BDC), which allows a volume customer to obtain delivery confirmation information electronically, and Priority Mail Retail Surcharge Delivery Confirmation (RSDC), which allows a customer to access delivery confirmation information over the telephone.²⁸ USPS Priority Mail rate design witness Sharkey included the costs of BDC in the attributed costs for Priority Mail, and proposes that this service be provided as part of the basic Priority Mail rate. *See* witness Sharkey's workpaper USPS-33N. Witness Plunkett proposes a rate of \$0.35 per piece for RSDC. *See* Table 2, USPS-T-40, p. 19.

United Parcel Service witness Luciani (UPS-T-4) proposes that BDC service not be included in the basic rate for Priority Mail, but that \$0.25 per piece be charged for BDC and \$0.60 per piece be charged for RSDC. UPS-T-4, p. 46, Tr. 26/14332. Also, witness Luciani proposes that over 70 percent of the costs of Mobile Data Collection Devices (MDCDs) be attributed to Priority Mail. UPS-T-4, p. 48, Tr. 26/14334. Based on his cost attribution and the Postal Service's Priority Mail Delivery Confirmation proposal, witness Luciani calculates cost coverages of 69 percent for

²⁸ BDC customers must apply their own barcodes to each piece and supply an electronic manifest for each shipment, while RSDC customers can enter pieces to be barcoded and sorted by Postal Service personnel. *See* USPS-T-40, pp. 16-17.

RSDC and 0 percent for BDC. UPS-T-4, p. 45, Tr. 26/14331. Witness Luciani does not seem to have taken into account the fact that, under the Postal Service's proposal, the costs for BDC have been included in the indicated piece rate for Priority Mail. *See* response to NDMS/USPS-T33-23, Tr. 4/1967.

Witness Luciani's testimony regarding delivery confirmation rates and the attribution of MCDC costs to Priority Mail and Standard Mail B was rebutted by two Postal Service witnesses, Lewis (USPS-RT-9) and Rios (USPS-RT-10). Witness Lewis, the Postal Service Operations Specialist in charge of the MDCCD program, discussed the system-wide improvements which will be realized by use of the MDCCDs (other than Priority Mail and Standard Mail B Delivery Confirmation) including: allowing faster and simple data entry in the Vehicle Management Accounting System, improving the technology used in the Collection Box Management System, implementing the Enhanced Street Performance system, implementing the Carrier Emergency Alert System, and improving various other service management programs, especially those related to special services. USPS-RT-9, Tr. 35/19015-38. Clearly, attributing the full costs of these systemwide improvements solely to Priority Mail and Standard B Mail is inappropriate.

The other Postal Service witness rebutting witness Luciani's proposals regarding Delivery Confirmation is witness Rios (USPS-RT-10). Her testimony specifically rebuts UPS witness Luciani's rate proposals for Priority Mail Delivery Confirmation, especially the negative effects of his proposal on demand for the service. USPS-RT-10, p. 2, Tr. 35/19033. NDMS concur with witness Rios that the Postal Service would

risk losing a valuable tool for management, carrier safety, and performance assessment if the Luciani proposal for Delivery Confirmation were implemented. The Postal Service proposal for Delivery Confirmation service should be recommended by the Commission.

6. No Shape-based Surcharge Should Be Imposed on Priority Mail.

United Parcel Service witnesses Sellick (UPS-T-2) and Luciani (UPS-T-4) each presents testimony in support of a surcharge on Priority Mail parcels. First, witness Sellick modifies the MODSSHAPE program found in Section III of LR-H-146 so that it includes data on Priority Mail in its output. *See* UPS-T-2, p. 18, Tr. 26/14177. Sellick finds a mail processing cost differential of 19.5 cents in Base Year, once adjusted by a piggyback factor and to include UPS's attribution of Priority Mail processing costs. *Id.*, p. 19, Tr. 26/14178.²⁹ Witness Luciani finds that, since the average weight difference between flats and parcels is 2.32 pounds (using witness Sellick's calculation of the average weight of Priority Mail flats and parcels), parcels pay \$0.093 more than flats in weight-related non-transportation costs under the Postal Service's proposed rate design. Witness Luciani therefore proposes a 10 cent surcharge on Priority Mail parcels. UPS-T-4, p. 44, Tr. 26/14330. The UPS surcharge would

²⁹ Using the Postal Service's attribution of mail processing costs, the cost difference is 12.7 cents per piece, according to witness Sellick. *See* workpaper UPS-Sellick-WP-1-III-A, p. 1.

apply to all Priority Mail parcels, regardless of weight.³⁰ See response to NDMS/UPS-T4-1(a), Tr. 26/14359.

United Parcel Service's proposal to impose a surcharge on Priority Mail parcels is yet another example of a shape-based surcharge proposal which lacks sufficient underlying information regarding the cost relationship between weight and shape. It is fallacious to assert that, because cost differences between flats and parcels exist, such cost differences are necessarily caused by shape. Neither witness Sellick nor witness Luciani presents sufficient evidence showing how much of their average cost differential between Priority Mail parcels and flats is driven by weight and how much is driven by shape. In fact, witness Luciani treats average weight-related and shape-related costs as interchangeable, by reducing his surcharge by the average difference in weight-related nontransportation costs paid by flats and by parcels. See UPS-T-4, p. 44, Tr. 26/14330.

If the traditional 2-cent per-pound weight-related nontransportation cost for Priority Mail has in the past merely served as a proxy for shape-related costs, as witness Luciani suggests by his methodology, then the 2-cent per-pound weight-related nontransportation cost built into Priority Mail rate design should be eliminated, and either a \$0.127 or \$0.192 surcharge should be imposed on Priority Mail parcels,

³⁰ This demonstrates a flaw in witness Luciani's use of average cost and weight differentials in a heterogeneous subclass such as Priority Mail: Luciani's surcharge not only fails to take into account the enormous per-piece contribution to institutional costs paid by heavyweight Priority Mail, it applies to rate cells in which no flats ever appear (6-70-pound flats could be said to be rare), not just to rate cells in which there is a mix of flats and parcels.

depending on whether the Commission accepts the Postal Service's mail processing cost attribution or that presented by its competitor. On the other hand, if the average cost differential between flats and parcels is caused by some combination of weight-related and shape-related costs, then neither witness Sellick nor witness Luciani has presented sufficient information about the relationship between those costs to give the Commission an adequate basis to recommend a new surcharge.

D. The Coverage Factor for Priority Mail Should Not Be Increased

Two intervenors have submitted substantive testimony regarding Priority Mail in this docket: United Parcel Service and NDMS. Neither specifically proposes an alternative to the coverage factor requested by the Postal Service for Priority Mail. NDMS also develops a proposed rate schedule based on the Postal Service's amended coverage factor.³¹ Should the Commission consider a different coverage factor for Priority Mail, NDMS submit that, based on the 39 U.S.C. section 3622(b) noncost criteria, any new coverage factor for Priority Mail should be lower than that proposed by the Postal Service.

³¹ The Postal Service originally requested a cost coverage for Priority Mail of 198 percent. After Priority Mail Test Year transportation costs were revised, the requested coverage was lowered to 192 percent to maintain the same target revenue. See response of witness Patelunas to UPS/USPS-T33-36, Tr. 13/7293-96.

1. Priority Mail's Delivery Performance Is Not Good and the Postal Service's Estimation of Priority Mail's Value of Service Is Too High

Postal Service cost coverage witness O'Hara (USPS-T-30) proposes a relatively high cost coverage for Priority Mail because of Priority Mail's "high intrinsic value of service." According to witness O'Hara, Priority Mail "enjoys the same priority of delivery as First-Class letters, receives even greater use of air transportation in view of the two-day service standard between most metropolitan areas, and enjoys the convenience of the collection system for the unzoned two-pound rate packages that constitute a large share of its volume." USPS-T-30, p. 27, ll. 3-7. However, despite its high service standards (and despite its very name), Priority Mail suffers from chronically poor delivery performance, as shown by Dr. Haldi in NDMS-T-2, pp. 59-65, Tr. 20/10352-58.³² Also, according to Postal Service policy, the collection system is no longer available for stamped Priority Mail weighing more than one pound.³³ First-Class Mail faces no equivalent limitation on its access to the collection system. The Commission's assessment of Priority Mail's intrinsic value of service should be based on actual Priority Mail performance data made available by the Postal Service,

³² Priority Mail performance has been consistently worse than First-Class Mail performance. See comparison of Priority Mail and First-Class Mail ODIS data for FY 1995-97, Tr. 2/412-15, and of Priority Mail and First-Class Mail delivery performance, United States Postal Service, 1997 Comprehensive Statement on Postal Operations, p. 45.

³³ See response of witness Sharkey to NDMS/USPS-T33-11 (Tr. 4/1959) and response of witness O'Hara to APMU/USPS-T30-1 (Tr. 2/117).

not on impressive but unmet service standards. *See* response to UPS/NDMS-T2-6, Tr. 20/10421.

2. Priority Mail Is Losing Ground in a Highly Competitive Market Because it Falls Short of its Delivery Standards, and Lacks the Features of Many Nonpostal Products with Which it Competes

Priority Mail participates in a fast-growing but highly competitive market. It lacks many features of its nonpostal competition, and suffers from poor delivery performance (as discussed, *supra*). As a result, although Priority Mail volume has grown dramatically, especially unzoned Priority Mail volume, Priority Mail's market share has been in decline. *See* NDMS-T-2, pp. 70-73, Tr. 20/10363-66. Also, most Priority Mail volume growth has been in the unzoned portion; the growth of heavyweight Priority Mail has lagged far behind. *See* NDMS-T-2, p. 24, Table 2, Tr. 20/10317. Postal Service experience has shown that market share, once surrendered, is difficult if not impossible to recapture in a competitive market. The Commission should recommend a coverage factor for Priority Mail at or below the level proposed by the Postal Service to prevent further damage to this important Postal Service product.

Measured both by piece volume and by revenue, Priority Mail's share of the two-day delivery market has declined since 1988. In 1988, Priority Mail's share of the two-day market was 76.9 percent by volume and 47.8 percent by revenue. *See* N-DP/USPS-T11-50, Docket No. R94-1. By 1996, Priority Mail's market share had declined to 62.3 percent by volume and 44.7 percent by revenue. *See* NDMS/USPS-

T33-30, Tr. 4/1973-75.³⁴ Priority Mail's market share by volume in calendar year 1996 for two-pound-and-under pieces was 74.1 percent, and 57.2 percent by volume for pieces weighing more than two pounds. *See* NDMS/USPS-T33-8, Tr. 4/1954. The difference between market share by volume and market share by revenue in both years, as well as the difference between 2-pound-and-under market share and 3- to 70-pound market share, suggests that what market share Priority Mail has left is due in large part to increasing volumes of underpriced, low revenue unzoned 2-pound-and-under pieces.

Witness Sharkey blamed Priority Mail's declining market share on its "lack of certain service features which are considered important by expedited service customers." Specifically, witness Sharkey listed Priority Mail's lack of guaranteed delivery, delivery confirmation with track-and-trace, flexible payment options, volume discounts, and reliable pickup services as "the areas in which Priority Mail has the most unmet needs." Response to NDMS/USPS-T33-25, Tr. 4/1968-69. The Postal Service's hidden surcharge on zoned Priority Mail, discussed *supra*, also has certainly weakened Priority Mail's position in the 6- to 70-pound market.³⁵

³⁴ Witness Sharkey later revised Priority Mail's 1996 overall two-day market share by volume downward to 62.3 percent without updating the percentages of market share by weight. *See* NDMS/USPS-T33-25 (Tr. 4/1968-69) and Tr. 4/2117-8. Overall market share by volume was 76 percent in 1990 and 72 percent in 1993. *Op. & Rec. Dec.*, Docket No. R94-1, p. V-36. The Commission stated in that docket that market deterioration supports a below system-wide average rate increase. *Id.*

³⁵ While the rates for 5-pound-and-under Priority Mail are somewhat lower than comparable published (undiscounted) rates for products offered by the Postal Service's major competitors, note that at least one competitor, United Parcel Service, offers a comparable product (3-day select) with published rates in the 6- to 70-pound weight range lower than Priority Mail rates. *See* attachment to USPS/NDMS-T2-25,

3. The Priority Mail Processing Center Contract Has Increased Costs, and Will Likely Degrade Service

Dr. Haldi has demonstrated that the Postal Service's contract with Emery Worldwide Airlines³⁶ to operate a Priority Mail processing and transportation network (1) has increased costs during Test Year without realizing expected savings, and (2) may degrade performance for some Priority Mail within the area covered by the contract. First, Priority Mail's cost coverage is already higher than it appears — since cost reductions caused by the contract were not credited to Priority Mail, Priority Mail's cost attribution is too high. Also, Priority Mail's value-of-service (which includes delivery performance), already overestimated by Postal Service cost coverage witness O'Hara (USPS-T-30), may degrade further under the contract. These factors indicate that raising the cost coverage for Priority Mail above that proposed by the Postal Service (and incorporated in NDMS proposed rates) would be inappropriate.

a. The Postal Service Underestimated the Cost Savings Caused by the Priority Mail Processing Center Contract

Under the Priority Mail Processing Center (PMPC) contract, Emery will perform many Priority Mail processing and transportation functions currently performed by the Postal Service within the contract service area. PMPC facilities will touch in some manner approximately 30 percent of Priority Mail, so program costs for

Tr. 20/10464-77.

³⁶ The contract is filed in this docket as LR-H-235.

the PMPC network are, not surprisingly, high.³⁷ But, as Priority Mail is transferred to the PMPC network and out of the Postal Service, substantial cost reductions in attributable Priority Mail transportation and mail processing costs would likewise be expected. Every piece of Priority Mail handled by Emery instead of the Postal Service should reduce Priority Mail's volume variable transportation and mail processing costs, as well as increase costs paid under the contract. As Dr. Haldi has shown, these cost reductions likely have been underestimated. NDMS-T-2, pp. 74-77, Tr. 20/10367-70.

The Postal Service reported \$127 million in direct cost reductions: \$82 million in cost reductions to purchased air transportation (cost segment 14, component 142) and \$45 million in cost reductions to clerks and mailhandlers (cost segment 3). *See* LR-H-10, Exhibit C, p. 4. There also appears to have been a cost reduction of as much as \$25 million due to the piggyback effects of the clerk and mailhandler cost reductions. *See* USPS/NDMS-T2-5, Tr. 20/10436. The net increase to Priority Mail attributable costs is therefore approximately \$113 million.

³⁷ The total PMPC costs attributed by the Postal Service to Priority Mail in Test Year 1998 are \$265 million. These costs are contained in three cost components: purchased air transportation (cost segment 14, component 142 — \$100 million); purchased highway transportation (cost segment 14, component 143 — \$100 million); and supplies and services (cost segment 16, component 187 — \$65.423 million). *See* LR-H-10, Exhibit B. Originally, the costs for highway transportation and supplies and services were attributed entirely to Priority Mail, while the cost for air transportation under the contract was attributed to several classes and subclasses along with the rest of purchased air transportation costs. Witness Patelunas later revised his testimony so that PMPC air transportation costs were distributed solely to Priority Mail, increasing the attributable costs of Priority Mail by \$70 million. *See* response to UPS/USPS-T33-36 (Tr. 13/7293-94).

Dr. Haldi, in his testimony (NDMS-T-2, pp. 74-78, Tr. 20/10367-71), discusses the manner in which cost reductions caused by the PMPC contract are underestimated. First, the PMPC contract causes only \$82 million in purchased air transportation cost reductions in Test Year 1997, while causing \$100 million in purchased air transportation cost increases, for a net purchased air transportation cost increase of \$18 million which is not even based on actual cost data.³⁸ Even more glaring is the fact that the Postal Service credited no cost reductions to Priority Mail ground transportation, even though by its own account under the contract the Postal Service will (by its own account) be purchasing \$100 million worth of ground transportation for Priority Mail from Emery. NDMS addressed the lack of highway transportation cost reductions with several Postal Service witnesses. Both witness Tayman (USPS-T-9) and witness Patelunas (USPS-T-15) confirmed that the attribution of ground transportation costs was not updated to reflect the fact that a large portion of Priority Mail volume will be transported by Emery rather than the Postal Service during the Test Year. Tr. 9/4531-32, Tr. 13/7320. The net 104 percent increase in Priority Mail ground transportation costs should certainly be offset by significant cost reductions, based on both a redistribution of costs to reflect the fact that less Priority

³⁸ Witness Tayman explained that the unusually round numbers for air and highway transportation costs were estimates given to him by the Priority Mail Redesign program managers between February and April 1997, before the contract with Emery was even awarded (on April 24, 1997). Tr. 9/4534. The Postal Service has made no effort to substitute actual figures. Tr. 9/4535.

Mail is being transported by the Postal Service, and on phasing out existing highway transportation contracts.³⁹

The net cost of the PMPC contract has been overestimated by a significant amount in the Postal Service's proposal. This means that the proportion of institutional cost contribution to actual costs included in the Postal Service's target revenue for Priority Mail is greater than is suggested by the Postal Service's coverage factor. Since the Postal Service's target revenue is based on overestimated costs, the "real" cost coverage factor for Priority Mail in the Postal Service's proposal is higher than 193 percent.⁴⁰

b. Service for Priority Mail Will Likely Degrade as a Result of the Priority Mail Processing Center Contract

The PMPC contract, which was designed to improve Priority Mail service and delivery performance, could actually cause Priority Mail service to decline even further during Test Year for at least three reasons. The existence of the contract, and the

³⁹ The duration of highway transportation costs is typically four years (*See* Tr. 7/3839, ll. 14-16), so approximately one-fourth of the 14,781 highway transportation contracts (number as of August, 1995, *see* FGFS/USPS-T13-5, Tr. 7/3564) expire each year. Renegotiated contracts would take into account the fact that a large amount of Priority Mail is being transported under the contract with Emery.

⁴⁰ Dr. Haldi did not reduce the Postal Service's proposed coverage factor, so that the Commission could see the effect of his rate design changes, in accordance with the Commission's request in Docket No. R94-1.

improved service it promises, should therefore not be used to justify a higher cost coverage for Priority Mail.⁴¹

First, the two-day, 96.5 percent service requirement imposed on Emery for Priority Mail sent entirely within the Phase I service area of the contract is measured from when the Postal Service tenders mail to Emery to when Emery tenders it back to the Postal Service. Whether these pieces will be returned to the Postal Service in time for same day delivery is not at all clear at this point. Therefore a 2-day standard for Emery does not necessarily mean that Priority Mail processed by Emery will enjoy 2-day end-to-end delivery by the Postal Service.

Also, under the contract, all Priority Mail either originating from or being delivered to addresses within the Phase I service area of the contract must be consolidated in 10 Priority Mail Processing Centers, likely with detrimental effect on overnight Priority Mail that is far from a PMPC, but within the Phase I service area. For example, a piece of Priority Mail being sent locally in Portland, Maine, rather than being delivered overnight, likely would be sent to a PMPC in Boston, processed by Emery, then returned to Portland for delivery. *See* response to USPS/NDMS-T2-2(a), Tr. 20/10431-32. As Dr. Haldi points out, National Newspaper Association witness Speights (NNA-T-2) discusses similar problems with degradation of service caused by such “massing of mail.” *See* NNA-T-2, pp. 4-5, Tr. 27/14895-96.

⁴¹ Witness O’Hara did not consider the effects of the PMPC contract on service when setting the original cost coverage for Priority Mail. Tr. 2/416, ll. 7-17.

Finally, Priority Mail users who currently plant load directly to Airport Mail Centers will no longer be able to do so; instead, they will have to enter Priority Mail at a PMPC, with detrimental effect on service for those customers. *See* response to USPS/NDMS-T2-2(a), Tr. 20/10431-32.

E. The Commission Should Recommend the Rates for Priority Mail Proposed by NDMS

Priority Mail has been an important and profitable Postal Service product, which participates in a highly competitive market. Unfortunately, zoned 6- to 70-pound Priority Mail has become increasingly less competitive, as the effects of maintaining lower-than-indicated 2-pound-and-under rates and of applying a mark-up to distance-related transportation costs drive up the rates for zoned Priority Mail. Dr. Haldi proposes rates for Priority Mail which are competitive to all weights and across all zones, without imposing disproportionate revenue burdens on either zoned or unzoned Priority Mail. The rates for Priority Mail proposed by NDMS should be recommended by the Commission as the first step in reestablishing Priority Mail as a successful product. Hopefully, the Postal Service will focus thereafter on improving the value of service and speed of performance of Priority Mail as the next step to even greater success.

III. THE POSTAL SERVICE'S STANDARD A RESIDUAL SHAPE SURCHARGE SHOULD BE REJECTED

The Postal Service's case for a Standard A Residual Shape surcharge is incomplete and nonpersuasive. It has failed to supply the specific documentation and analyses requested by the Commission in Docket No. MC95-1. The Postal Service does not even concede that the concerns articulated by the Commission's in that docket — whether the revenue earned by parcels exceeds the costs incurred — is **relevant** to its surcharge rate design.

No part of the mailing community has supported the Postal Service's proposal, even those mailers and associations which would supposedly benefit.⁴²

Therefore, no Standard A residual shape surcharge should be recommended in this docket. Should the Commission nevertheless continue to feel that some action is necessary at this time, it should accept Dr. Haldi's proposal and consider recommending a shell classification, without any specific rate, and request the Postal Service to submit a new proposal which addresses the more important deficiencies of the current proposal.

Further, should the Commission feel compelled to go beyond a shell classification, and should it adopt witness Crum's de-averaged bottom-up costs as the

⁴² Parcel Shippers Association (PSA) witness Jellison states that some of the "victims" (*i.e.*, Standard A nonparcel mailers) of the "below cost-rate problem" **oppose** the surcharge. Specifically, he notes that PSA members "are predominantly Standard 'A' letter and catalog mailers" who "fully understand the implications of their **absolute opposition** to the Standard 'A' surcharge." Response to USPS/PSA-T1-24, Tr. 24/13027, emphasis added.

basis for a surcharge at this time, then the Commission should accept Dr. Haldi's proposal that the surcharge not exceed 2 to 3 cents, for the reasons set out in his testimony and this Brief.

A. **The Postal Service Proposal Does Not Meet the Standards Set by the Commission in Docket No. MC95-1 for Future Standard A Parcel Rate Design**

The Postal Service's proposal for a Standard A residual shape surcharge in the instant docket arises out of the testimony of two UPS witnesses (Blaydon and Luciani) who sought separate rate categories for Standard A parcels three years ago in Docket No. MC95-1. (*See* USPS-T-36, p. 11.) In its *Opinion & Recommended Decision* in Docket No. MC95-1, the Commission discussed at length this proposal by UPS (pp. V-210 to V-230). But, the Commission found that the evidence was insufficient to support any proposed Standard A Mail parcel rates in that docket, while the Postal Service had already undertaken "analyses of parcel costs and market characteristics," and was "about to provide the data necessary to develop a rate design which best resolves the problems identified on this record by PSA and RIAA," and "produce information which will enable the Commission to implement a **balanced** solution." (*Id.*, at para. 5566-67, emphasis added.) The Commission urged "the Postal Service to develop expeditiously a comprehensive parcels proposal with supporting information. The below cost-rate problem cannot be allowed to stand for an unreasonable and unwarranted period of time." (*Id.*, at par. 5569.) Two dissenting commissioners

expressed their support for imposing a Standard A residual shape surcharge immediately.

In response to the Commission's request, the Postal Service has proposed a 10-cent surcharge on every piece of Standard A Mail that is neither letter- nor flat-shaped — so-called residual shaped pieces. (USPS-T-36, p. 12.) In light of these facts, it would be valuable to examine the extent to which the Postal Service's proposal responds to the Commission's request.

1. The Postal Service's Proposal Does Not Address the Alleged "Below-Cost Rate Problem"

As Dr. Haldi points out in his testimony, the Postal Service's justification for its proposed residual shape surcharge focuses myopically on costs, notwithstanding the Commission's concern that revenues from parcels were less than the costs attributed to parcels. NDMS-T-3, p. 20, 23/12151. According to witness Moeller, this surcharge proposal "responds to the Commission's and the dissenting Commissioners' concerns by increasing revenue from these pieces, thereby helping to alleviate the 'below cost rate problem.'" (USPS-T-36, p. 12.) However, witness Moeller also stated that "the 'difference between revenues and costs' incurred by parcels **is not relevant** to the rate design" underlying the residual shape surcharge (Tr. 6/2816-17, NDMS/USPS-T36-1-2, emphasis added.) This was because "[t]he point of the surcharge isn't to assure cost coverage or that the revenues exceed the costs; it is to recognize cost differences between these two groupings of mail." (Tr. 6/2948, ll. 19-22.)

Later, witness McGrane's rebuttal testimony, USPS-RT-12, not only compared Standard A parcel costs to flat costs, it also compared parcel revenues to flat revenues (without conceding "whether this is an appropriate method to evaluate the surcharge"), p. 9, ll. 3-4, Tr. 35/18958. Including nonprofit parcels in his analysis (*id.*, n. 3), witness McGrane calculated that "in Base Year 1996 parcels cost 40.3 cents per piece more than flats and brought in 24.6 cents per piece more revenue than flats."⁴³ In other words, witness McGrane's testimony is consistent with that of witness Moeller — both refuse to examine the continued existence of any "below cost-rate problem" for Standard A parcels. Instead, the focus of witness McGrane's testimony appears to be whether Standard A parcels make the **same contribution to institutional costs** as are made by Standard A flats (this standard offers an interesting precedent which will doubtless spawn a multiplicity of future discount and surcharge proposals).

Witness McGrane neglects to mention that his 15.7 cent differential is strongly affected by the costs and revenues of parcels in the nonprofit subclass.⁴⁴ The revenue/cost differential for Standard A commercial (Regular and ECR combined) parcels has dropped from **19.1 cents** in FY 1994 to **11.5 cents** in FY 1995 to **7.4 cents** in FY 1996, while the revenue/cost differential for Standard A Regular parcels alone

⁴³ Witness McGrane described this 15.7 cent differential as being "between unit costs and unit revenues." *Id.*, ll. 15-17.

⁴⁴ The proposed parcel surcharge is the only rate category for which costs of different subclasses are averaged together to support a desired result. In this respect, it would set another interesting precedent.

has dropped from **8.4 cents** in FY 1995 to **4.9 cents** in FY 1996.⁴⁵ See discussion below in Sections III.A.1.a. and III.A.1.b.

a. **The “Below Cost-Rate Problem” of Standard A Regular Parcels Keeps Diminishing**

LR-PCR-38 (filed in Docket No. MC97-2) provided the Postal Service’s calculations of **cost per piece** for FY 1995. Table 3 in that library reference, the Postal Service’s “**FY 1995 Third-Class Bulk Rate Regular Other Costs by Shape,**” showed the attributable cost per piece for bulk third-class parcels was **55.0 cents**. Witness Crum’s testimony in this docket identifies the average attributable cost per piece of Standard A Regular parcels (which constitute 88.5 percent of all BY 1996 Standard A parcel volume) as **51.3 cents** in the Base Year for this docket, FY 1996 (USPS-T-28, Exhibit K, Table 3B(1)). Additional detail is available for Standard A Regular and ECR parcels combined. No cost data for Third Class Bulk Rate Regular non-carrier-route parcels have been identified for FY 1994.

The **revenue per piece** for Standard A Regular parcels has also increased by more than 10 percent since FY 1994. This revenue increased from **41.4 cents** in **FY 1994** (Attachment to DMA/USPS-T28-1, Tr. 5/2176) to **46.6 cents** in **FY 1995** (Attachment to DMA/USPS-T28-1, Tr. 5/2177) and then stabilized at **46.4 cents** in **FY 1996** (USPS-T-28, Exhibit K, Table 1).

⁴⁵ Witness Jellison, PSA-T-1, calculated the Standard A parcel revenue/cost differential to be 4.85 cents. See PSA-T-1 Exhibit A, Tr. 24/12971; see also Tr. 35/18977, ll. 3-11.

Thus, by this analysis, the revenue/cost differential for Standard A Regular parcels was **8.4 cents** (55.0 - 44.6 cents) in **FY 1995**, and **4.9 cents** (51.3 - 46.4 cents) in **FY 1996**.

b. The “Below Cost-Rate Problem” of Standard A “Commercial” Parcels Keeps Diminishing

The **cost per piece** for Standard A Regular and ECR parcels combined (Standard A commercial) has also decreased consistently since FY 1994. This cost decreased from **57.2 cents** in **FY 1994** (Attachment to NDMS/USPS-T28-18, Tr. 5/2232) to **54.1 cents** in **FY 1995** (Attachment to NDMS/USPS-T28-18, Tr. 5/2234) and down further to **51.6 cents** in **FY 1996** (USPS-T-28, Exhibit K, Table 3).

The **revenue per piece** for Standard A commercial parcels has also increased substantially since FY 1994. This revenue increased from **38.1 cents** in **FY 1994** (Attachment to DMA/USPS-T28-1, Tr. 5/2176) to **42.6 cents** in **FY 1995** Attachment to DMA/USPS-T28-1, Tr. 5/2177) and up to **44.2 cents** in **FY 1996** (USPS-T-28, Exhibit K, Table 1).

Thus, the revenue/cost differential for Standard A commercial parcels has fallen dramatically from **19.1 cents** (57.2 - 38.1) in FY 1994 to **11.5 cents** (54.1 - 42.6) in FY 1995 to **7.4 cents** (51.6 - 44.2) in FY 1996.

c. The Postal Service’s Proposal Does Not Acknowledge that the “Below Cost-Rate Problem” is Disappearing

Since the Postal Service’s surcharge proposal does not look to the existence of a “below cost-rate problem,” the Postal Service either has not examined its data —

showing the dramatic decrease in the revenue/cost differential since FY 1994 — or it has responded to those data by seeking to divorce the surcharge from the reason given by the Commission for its request that the Postal Service file a proposal which would provide separate rate treatment of Standard A parcels.

2. The Postal Service Has Not Presented its Analysis of Market Characteristics, and the Volume and Revenue Estimates from the Surcharge Appear to be Grossly Inflated

As noted above in section III.A., the Commission's *Opinion & Recommended Decision* for Docket No. MC95-1 observed that the Postal Service had already undertaken "analyses of parcel costs and market characteristics." However, it is not clear from the record of this docket what happened to the second of these analyses — market characteristics — undertaken by the Postal Service more than two years ago.⁴⁶

The Postal Service has presented an analysis of "Standard Mail (A) Unit Costs by Shape" (LR-H-108, which, with amendments, later became Exhibit K of USPS-T-28). Exhibit K does "estimate" the unit attributable costs for Standard A Mail flats and parcels. USPS-T-28, Exhibit K, p. 1. However, **no analysis** of market characteristics has been presented, notwithstanding the Commission's expectations expressed in Docket No. MC95-1.

The Postal Service's proposed residual shape surcharge would increase the rates paid by some Standard A parcel mailers over 55 percent. (*See* response to NAA/USPS-

⁴⁶ The *Opinion & Recommended Decision* for Docket No. MC95-1 is dated January 26, 1996.

T36-4, Tr. 6/2777, demonstrating that rates paid by Standard A Regular parcels entered at the DSCF would increase by this amount.) Additionally, witness Moeller testified that, even before imposition of the residual shape surcharge, “[s]ome nonletters [sic] categories are already receiving greater than average rate increases.” (USPS-T-36, p. 13.) But witness Moeller stated that the Postal Service adopted a low passthrough of the flat/parcel cost differential “to mitigate the impact of the potential increase in rates on customers.” *Id.*

This asserted “mitigation” does not explain why the Postal Service believes that Standard A “residual shape” mailpieces will achieve a 22 percent increase in volume over two years, while absorbing double-digit rate increases (some of which exceed 50 percent). Specifically, the estimated Base Year 1996 Standard A parcel volume was 983 million (USPS-T-28, Exhibit K, Table 3) and witness Moeller estimates that an estimated 1.2 billion Standard A “residual shape” mailpieces would be subject to the surcharge in the test year (after rates). (*See* response to PSA/USPS-T36-8, Tr. 6/2886.) Without a supporting demand analysis, such projections are not tenable.

3. The Postal Service’s Proposal Does Not Address Concerns Raised by RIAA and PSA in Docket No. MC95-1

Additionally, in Docket No. MC95-1, the Commission directed the Postal Service to provide a rate design answer to “the problems identified on this record by PSA and RIAA.” The Commission identified several such problems:

- PSA discussed the lack of record evidence that shape is a dominant cost influence in mail handling, *Op. & Rec. Dec.*, Docket No. MC95-1, para. 5540;
- PSA discussed the lack of record evidence that parcels are systematically more costly to handle than flats. *Id.*;
- PSA presented samples of the shape of many third-class parcels, demonstrating several have shapes that are far more like the shapes of flats than the shapes of other parcels. *Id.*, para. 5541;
- RIAA addressed the lack of data supporting a separate Standard A parcel rate, including no definition parameters of affected mailpieces, no identification of the different procedures (and resultant costs) for machinable and nonmachinable parcels, and no analysis of potential volume shifts among classes and subclasses of mail. *Id.*, para. 5544; and
- RIAA observed that “the calculation of the ‘average cost’ of a ‘parcel’ proves nothing about the range of costs that made up that average.” *Id.*, para. 5546.

The Postal Service has ignored most Commission requests for specific data.

a. **There Is Still No Record Evidence that Shape Is a Dominant Cost Influence in Mail Handling or that Parcels Are Systematically More Costly to Handle than Flats**

When witness Moeller was asked whether “the Postal Service has performed studies which show that shape is the factor that differentiates the costs of flats from those of nonflats,” he did not identify any such study. He only observed that “[w]itness Crum’s testimony (USPS-T-28) describes a study which measures the cost differences between flats and other nonletters.” *See* response to DMA/USPS-T36-9, Tr. 6/2747. Obviously, **measuring** a cost difference is not the same thing as documenting what **drives** or **causes** a cost difference, as witness Moeller himself has

testified. He observed that, where two hypothetical mailpieces of different shapes and weights have identical cost and revenue differentials:

that's a good thing that the revenue is being obtained for this additional cost of 33 cents but **ideally you would want to know what's causing that cost difference**. The pound rate is the right mechanism for getting that additional revenue if it is indeed weight that was causing the cost difference in that hypothetical. To the extent it was shape that was driving that difference, then there would be a basis for a shape surcharge and a lowering of the pound rate because weight would not have been what was causing the cost difference of 33 cents. [Tr. 7/3158, ll. 14-21, emphasis added.]

Here, witness Moeller appeared to agree with Dr. Haldi, who observed (regarding the proposed Standard A residual shape surcharge) that, "[w]ithout knowing what [the] cost really is, and the factors that drive that cost to be what it is, the development of **sensible cost-based rates** ranges between **difficult** and **impossible**." Response to USPS/NDMS-T3-35, Tr. 23/12224, emphasis added.

Witness Moeller later expressed his belief that "we have a study that shows that shape is a big cost determinant." Tr. 7/3159, ll. 1-2. As noted above, however, he did not point to any evidence that "shape is the factor that differentiates the costs of flats from those of nonflats."

Instead, as Dr. Haldi points out in his testimony, "[a] major failure of the Postal Service's filing in this case is the lack of any study demonstrating how the cost of handling various types and shapes of parcels varies with different cost-driving characteristics." NDMS-T-3, p. 23, Tr. 23/12154. Dr. Haldi observes that the data underlying the proposed surcharge provided by the Postal Service raise more questions than they answer:

The IOCS-based cost study sponsored by witness Crum exhibits remarkable, **virtually unbelievable, cost differences** for parcels of similar weight. Are these cost differences based on real cost-driving characteristics? Or do they simply illustrate the futility of relying exclusively on IOCS tallies to study parcel costs?

On the one hand, if the substantial cost differences developed by witness Crum are real, they **need to be investigated** in order to identify cost-drivers and quantify their impact. But no information is forthcoming on this important issue. Witness Crum appears indifferent to potentially important questions raised by his own study.

On the other hand, if the cost differences are **spurious**, and amount to nothing more than statistical outliers caused by small sample size, of course they should be **disregarded**. But **how much weight** can the Commission, or anyone else for that matter, **give to a study** if it produces **statistically meaningless results** and literally begs to have disregarded the **important differences** which it surfaces? [*Id.*, p. 24, Tr. 23/12154, emphasis added.]

Another weakness of witness Crum's analysis, cited by witness Moeller, is its reliance on the unproven **assumption** that weight has **no** effect on Standard A costs. Witness Crum expressly did not control for weight in his Docket No. R97-1 analysis, in contrast to his approach several months earlier in Docket No. MC97-2. He defended his approach in this docket with the observation that he has no data which show that weight has a significant impact on Standard A parcel costs (*i.e.*, the Postal Service has not studied this issue either). Response to NDMS/USPS-T28-26, Tr. 5/2242.

Witness Crum further stated that he does not know whether a four-ounce parcel incurs more costs than an eight-ounce parcel, yet he denied that he meant there was no explanation or data supporting the Postal Service's Standard A rate design (which, *inter alia*, charges more for a four-ounce parcel than it does for an eight-ounce parcel). (Tr. 5/2346, ll. 8-10; 5/2347, ll. 7-10.) As witness Jellison testified in this docket, "the

Postal Service made no effort to factor in the influence of weight on the cost of a parcel nor the amount of revenue that that parcel produced.” (Tr. 24/12967.)

Witness Crum did suggest that the only reason supporting the Postal Service’s current Standard A weight-based rates is the view that weight serves as a proxy for shape. He observed that “[t]here is also a factor of weight proxying for other characteristics such as changes in shape.” (Tr. 5/2346, ll. 5-6.)

Similarly, witness Moeller defended his proposed reduction in the pound rate for Standard A Regular with the argument that “the pound rate still has a role, albeit diminished, as a proxy for shape.” (USPS-T-36, p. 15.) Witness Moeller also observed that the “current Regular pound rate may be viewed as a proxy for changing shape mix as weight increases,” and would still have “a role as a proxy for shape,” even with the proposed residual shape surcharge. (*See* response to NAA/USPS-T36-6, Tr. 6/2779-80.)

b. The Postal Service’s Proposal Fails to Address the Fact That Some Parcels Have Shapes that Are Far Closer to the Shape of Flats than to the Shape of Other Parcels

In this docket, counsel for RIAA, in oral cross-examination of witness Crum, drew out the fact that the Postal Service’s residual shape surcharge proposal expressly would **treat identical mailpieces differently**, where one identical mailpiece is “prepared” as a flat and the other identical mailpiece is “prepared” as a parcel. Moreover, it is not clear that Postal Service would correctly identify the shape of such mailpieces. The IOCS instructions used to identify flats and parcels in the mainstream

rely on DMM C050, which does not refer to preparation as a criterion distinguishing flats from parcels. (Tr. 6/2372-2384.)

Witness Moeller also observed that certain mailpieces can meet the definitions of both parcels and flats. In fact, he said that it was no secret that “some parcel mailers may...be able to avoid the surcharge by mailing their smaller parcels as flats.” Tr. 7/3161, ll. 8-9; 7/3162, ll. 7-11. Obviously, any cost differences between identical parcels and flats due to mail makeup requirements are not caused by any difference in dimension.

The Postal Service’s proposed surcharge does not distinguish between parcels that meet the definition of a flat-shaped mailpiece, and parcels which have an irregular shape. In this manner also, the Postal Service proposal does not address PSA’s concern. Witness Moeller does argue, however, that the low passthrough of identified shape-based cost differences should overcome any challenges to the Postal Service’s proposal based upon the Postal Service’s failure to distinguish between high cost and low cost residual shapes in its Standard A parcel rate category. USPS-T-36 at 13-14.

This theme is repeated in witness Moeller’s response to a DMA interrogatory:

In this proceeding, the Postal Service has proposed a low passthrough of the cost differential underlying the residual shape surcharge. Among other factors, this measure should assuage the concerns of those who contend that there are pieces subject to the surcharge that have cost-causing characteristics similar to a flat.

See response to DMA/USPS-T36-3, Tr. 6/2740. However, since this “low passthrough” characterization is not applicable to any analysis of the Commission’s “below cost-rate problem” concern, this may explain witness Moeller’s dismissal of

the Commission's earlier perception of a "below cost-rate problem" as a justification for the proposed surcharge.

c. **The Postal Service's Proposal Still Lacks Adequate Definition Parameters of Affected Mailpieces, Identification of the Different Procedures (and Resultant Costs) for Machinable and Nonmachinable Parcels, and an Analysis of Potential Volume Shifts Resulting from the Surcharge**

i. The Postal Service's Proposal Still Lacks Adequate Definition Parameters of Affected Mailpieces

Dr. Haldi pointed out that the definition of a Standard A parcel presents fundamental problems. NDMS-T-3, p. 25, Tr. 23/12156. For example, mailpieces of identical size and shape can be flats or parcels, depending on the context. "Current Postal Service practices and procedures promote the conclusion that the terms 'parcel' and 'residual shape' may not provide meaningful criteria for purposes of determining accurate costs, or cost differentials, or for the design of cost-based rates." *Id.*

Witness Moeller's testimony characterized the surcharge as applying to "every piece of Standard Mail (A) that is neither letter- nor flat-shaped." USPS-T-36, p. 12. However, as witnesses Crum and Moeller have acknowledged, under the Postal Service's proposals some flat-shaped (but "parcel-prepared") mailpieces would also be subject to the surcharge.

The Postal Service's initial filing in **Docket No. MC97-2** had requested the following changes to the Domestic Mail Classification Schedule (Attachment A, p. 4):

- 321.25 **Residual Shape Surcharge.** Regular subclass mail is subject to a surcharge if it is not letter-, card-, or flat-shaped.
- 321.37 **Residual Shape Surcharge.** Enhanced Carrier Route subclass mail is subject to a surcharge if it is not letter-, card-, or flat-shaped.

The Postal Service's filing in **Docket No. R97-1** requested noticeably different changes to the Domestic Mail Classification Schedule (Attachment A, pp. 25-26, 29):

- 321.25 **Residual Shape Surcharge.** Regular subclass mail is subject to a surcharge if it is prepared as a parcel or if it is not letter or flat shaped.
- 321.37 **Residual Shape Surcharge.** Enhanced Carrier Route subclass mail is subject to a surcharge if it is prepared as a parcel or if it is not letter or flat shaped.
- 321.45 **Residual Shape Surcharge.** Nonprofit subclass mail is subject to a surcharge if it is prepared as a parcel or if it is not letter or flat shaped.

Witness Moeller stated it is no secret that flats and parcels can have the same dimensions. Yet witness Moeller repeatedly commented that mailpieces of identical weight and dimensions (length, width, and height) incur different costs depending on how they are characterized — as parcels or flats. (*See responses to DMA/USPS-T36-3, Tr. 6/2740; DMA/USPS-T36-9, Tr. 6/2747 and NAA/USPS-T36-5, Tr. 6/2778*). Then he observed that any inequities were not important, due to the low passthrough. *See response to DMA/USPS-T36-3, Tr. 6/2740.* The low passthrough was invoked repeatedly to justify various inequities caused by the Postal Service's proposed residual shape surcharge.

Witness Crum stated it was unlikely that a single Standard A bulk mailing would have both flats and parcels, differing only by the thickness of the mailpieces. (*See* response to NDMS/USPS-T28-9, Tr. 5/2219.) However, Dr. Haldi has discussed how photofinishers currently ship a significant volume of their mailpieces as mixed parcels (*i.e.*, flats and parcels combined), which reflects the current reality that flats and parcels pay the same rates. The proposed surcharge will force photofinishers either to pay the surcharge on all nonletter mailpieces, or to invest additional resources in *sorting and shipping flats separate from parcels, another expense imposed on these mailers over and above the 50 percent increase in their Standard A parcel rates (DSCF-entry 3/5 digit presort)*. *See* NDMS-T-3, pp. 5, 10, Tr. 23/12136, 12141; and Tr. 23/12244, l. 16 to 12245, l. 9.

Witness Crum observed that an individual residual shaped mailpiece could have the same unit attributable cost as the average flat in a given rate category. However, he discounted the possibility that there could be a type or subset of such residual shaped mailpieces. *See* responses to DMA/USPS-T28-13, Tr. 5/2190; DMA/USPS-T28-14, Tr. 5/2191. But witness Crum was evidently unaware that the surcharge applied to mailpieces prepared as a parcel. He stated that his definition of a parcel was drawn from the IOCS-defined categories of IPP Machinable, IPP Nonmachinable, Parcel Machinable, and Parcel Outside, a definition paralleling that of DMM C050. (*See* responses to NDMS/USPS-T28-3, Tr. 5/2200; NDMS/USPS-T28-13, Tr. 5/2226.) Yet, as counsel for RIAA pointed out, and witness Crum confirmed, the IOCS and DMM C050 definitions of a parcel—relied upon by witness Crum in his analysis—do

not reflect a mailpiece's "preparation as a parcel." Tr. 5/2375, l. 17 to 5/2376, l. 4; Tr. 5/2380, l. 9 to 5/2381, l. 8.

In fact, witness Crum further confirmed the overlap between the dimensions of flat-shaped pieces and of nonletter, nonflat-shaped pieces. Tr. 5/2377 ll. 5-10; 5/2381 ll. 4-10. Witness Crum also noted that IOCS tally clerks (whose data formed the basis for his analyses in Exhibit K), may well have identified flat-shaped pieces as parcels, the effect of which would be an overstatement of parcel costs. Tr. 5/2384 ll. 2-7.

Dr. Haldi identified another significant weakness in the Postal Service's current data collection systems: the fact that the Postal Service uses separate data systems for collecting information on (i) revenues and volumes, and (ii) costs. He observed that, for the Postal Service to obtain meaningful data for rate making purposes, it is essential that mailpieces be identified in the same manner in each of the two systems (*i.e.*, all pieces subject to the parcel surcharge should be identifiable as a parcel under the IOCS). As discussed above, that is not the current postal practice, as the proposed DMCS definition does not reflect the current DMM definition. Moreover, no mechanism exists by which the Postal Service has been able to identify correctly the actual rate category of such mailpieces when collecting the data used to compute cost allocations. NDMS-T-3, pp. 28-29, Tr. 23/12159-60.

RIAA's criticism from Docket No. MC95-1, given recognition by the Commission at that time, that the proposed Standard A parcel rates lack simple, clear definition parameters, remains applicable.

- ii. The Postal Service's Proposal Still Fails to Distinguish Between Machinable and Nonmachinable Parcel

Witness Moeller observed that the Postal Service did not consider a separate rate for machinable pieces in the course of its development of proposed rates for the parcel surcharge. (Tr. 6/2936, l. 24 to 6/2937, l. 1.) He expressed his belief that introducing a machinable discount to offset the proposed rate increase would be counter-productive. Also, witness Moeller cites the "low passthrough" of identified shape-based costs in defense of the Postal Service's decision not to recognize the cost-driving characteristics of machinability in its residual shape surcharge rate design. (*See* response to DMA/USPS-T4-23 (redirected to witness Moeller), Tr. 6/2751.) The Postal Service's proposal does not create any financial incentive for mailing parcels which are machinable or otherwise easier to handle. (*See* NDMS-T-3, p. 15, Tr. 23/12146; *see also* response to USPS/NDMS-T3-14, 23/12195.)

- iii. The Postal Service's Proposal Still Lacks Any Analysis of Potential Volume Shifts Resulting from the Surcharge

No analysis of potential volume shifts as a result of the parcel surcharge has been made available by the Postal Service in this docket, as discussed *supra*, at section III.A.2.

- iv. Calculation of the "Average Cost" of a "Parcel" Still Proves Nothing About the Range of Costs that Made Up that Average

Witness Moeller asserts that, if the Postal Service were to identify and recognize **proven** cost-driving factors such as presortation, dropshipment, or machinability in its proposed rates for Standard A parcels, the result “would essentially split this relatively small segment of Standard Mail (A) into two smaller groups.” (*See* response to DMA/USPS-T4-23 (*redirected to witness Moeller*), Tr. 6/2750.) This explanation is not persuasive.

First, “relatively small” is evidently defined as something between 983 million and 1.2 billion pieces. *See* witness Moeller’s response to PSA/USPS-T36-8, Tr. 6/2886. In sharp contrast to the view that Standard A parcel volume is “small”, witness Crum justified the residual shape surcharge as necessary because of the **substantial absolute volume of Standard A parcels**, USPS-T-28, p. 10.

Second, the estimated Test Year volume of Standard B Parcel Post — for which the Postal Service has proposed a **barcode discount** (as well as three distinct destination entry rate schedules) — is only **231 million, less than one-fifth** the estimated Test Year volume of Standard A parcels, Exhibit USPS-6A, p. 7. Witness Moeller even recognized that cost savings to the Postal Service from a prebarcoded Standard A parcel “are likely to be similar to those for a prebarcoded Standard (B) parcel,” since Standard A parcels will also be processed on parcel sorters with barcode readers. Yet only the Standard B parcel rates recognize the cost avoidance. (*See* responses to DMA/USPS-T36-10, Tr. 6/2748; PSA/USPS-T37-2, Tr. 6/2888.)

Third, witness Crum identified over 72 percent of Standard A commercial non-ECR parcels as machinable, and intrinsically eligible for the barcode discount. *See*

response to RIAA/USPS-T28-2, Tr. 5/2251. There were over 875 million such parcels in FY 1996. USPS-T-28, Exhibit K, Table 1. Thus, over 630 million parcels in this one subclass alone could qualify for such a discount.

Fourth, witness Crum identifies 698 million Standard A parcels which were presorted in FY 1996. (USPS-T-28, Exhibit K, Table 7.) While some cost avoidance from presortation (of nonletters) is recognized (and would be recognized under the Postal Service's proposal), the Postal Service did not propose Standard A parcel presortation discounts which recognize cost avoidance based on the **actual** cost of handling Standard A **parcels**. (NDMS-T-3, pp. 33-34, Tr. 23/12164-65.)

In sum, at the same time that the Postal Service seeks its parcel surcharge, it chose not to recognize in its proposed rate design tens of millions of dollars of cost avoidance by hundreds of millions of these same Standard A parcels.

Furthermore, Dr. Haldi observes, "cost differentials and cost drivers within the category of parcels have not been subjected to statistical study." (NDMS-T-3, p. 30, Tr. 23/12161.) For example, the Postal Service never studied whether rolls, outsides, and other odd shapes incur extremely high costs. Postal Service witnesses did observe that some Standard A parcels can be cased with letters and flats, *see* response of Witness Crum to UPS/USPS-T28-11, Tr. 5/2267-68, while other parcels cannot, *see* response of witness Moden to DMA/USPS-T4-51, Tr. 11/5745-46. No such differences in cost incurrence were reflected in the Postal Service's rate design.

Also, as noted above, Dr. Haldi observed that witness Crum's cost study "exhibits remarkable, virtually unbelievable, cost differences for parcels of similar

weight.” (NDMS-T-3, p. 24, Tr. 23/12155.) But there is (again) no evidence in this docket as to whether the cost differences in witness Crum’s study are based on real cost-driving characteristics, or simply reflect the frailty of studies based on IOCS. (*Id.*, *see also Op. & Rec. Dec.*, Docket No. R94-1, pages III-1 through III-10.)

Witness Moeller stated that no other alternatives to the surcharge were explored in preparation for this docket, evidently due to the Postal Service’s concern “to avoid unwarranted complication of the rate structure” resulting from a more cost-based rate design. (*See response to RIAA/USPS-T28-4 (redirected to witness Moeller)*, Tr. 6/2891.) Witness Moeller further assures us that the design of this surcharge “is also desirable from the point of view of both the mail user and the Postal Service in that it is simple, and it achieves a reasonable measure of de-averaging without adding significant complexity to the rate structure for Standard Mail (A).”⁴⁷ USPS-T-36, p. 15.

Witness Moeller acknowledged that the Postal Service did not consider a separate rate for machinable pieces in its preparations to develop proposed rates for the residual shape surcharge. Tr. 6/2936, l.24 to 6/2937, l. 1. Again invoking the “low passthrough” of parcel/flat cost (not net revenue) differentials, witness Moeller argued that introducing a machinable discount to offset the proposed rate increase would be counter-productive. *See response to DMA/USPS-T4-23 (redirected to witness Moeller)*, Tr. 6/2751.

⁴⁷ The Postal Service has apparently discerned that **simplicity of structure** is of far greater concern to commercial mailers of Standard A parcels than to mailers of First-Class one-ounce-and-under single-piece nonstandard mail (*see* Section I, *infra*).

When witness Moeller was asked about the inconsistency between identifying shape-based costs when calculating the costs incurred, respectively, by Standard A parcels and flats, and lumping together all letters, flats, and parcels when identifying and accounting for the costs avoided by the presortation and dropshipment of Standard A parcels, he responded that the Standard A parcel/flat cost differential calculated by witness Crum is:

a large amount and we pass through a very small amount of it, so that is my effort at fairness and equity there is that, and add this to the list, to the extent they are denied or their dropship discounts are perhaps lower than they would be if you had distinct dropship discounts by shape then at least they are not having their rates pushed up by 100 percent passthrough of Witness Crum's large cost difference. [Tr. 6/2945 ll. 3-10.]

Witness Moeller even testified that his Procrustean Standard A residual shape surcharge "continues the development of a price structure which better reflects significant cost differences." (USPS-T-36, p. 12.) The evidence suggests otherwise, however.

B. The Record in this Docket Does Not Support the Proposed Surcharge

1. Substantial Unrebutted Testimony Show the Data on Which the Surcharge is Premised Are Unreliable

The Postal Service offered rebuttal testimony by two witnesses seeking to rehabilitate the proposed surcharge (witness Degen, USPS-RT-6, pp. 44-46, and witness McGrane, USPS-RT-12, pp. 8-14). However, their testimony addresses only two criticisms by witness Andrew that the proposed surcharge is too high based on his comparison of costs and revenues. All other criticisms of the proposed surcharge in

this docket, by witnesses Haldi, Andrew, and Jellison, remain unrebutted on the record.⁴⁸

Dr. Haldi challenged the basic credibility of the data relied upon to support the proposed surcharge in the Postal Service's case-in-chief:

The data supplied by witness Crum raise troubling questions. Parcels with a comparatively low unit mail processing cost have a comparatively high delivery cost, and variations in unit cost appear uncorrelated, or even inversely correlated, with weight differences.... are these cost differences meaningful at all? Do these cost differences **reflect real characteristics that differ among the various shapes of different parcels?** Or do they represent nothing more than statistical variation arising from small sample size?

The cost differences are so enormous as to render the data worthless. Some unit costs appear to be several standard deviations from the average. If they reflect real, shape-driven causality (*e.g.*, rolls, spheres or other unusual shapes), then the Commission and the Postal Service need to know far more about them, and mailers deserve to have them quantified in a statistically reliable manner. [*Id.*, p. 35, Tr. 23/12166, emphasis in original.]

Dr. Haldi also testified (NDMS-T-3, p. 29-30, Tr. 23/12160-61) that:

- The conceptual foundation of the cost data used for rate making is gravely deficient;
- Cost models are lacking;
- The causative roles of shape, weight, and other potentially important factors are ambiguous;
- Cost differentials and cost drivers within the category of parcels have not been subjected to statistical study; and

⁴⁸ Witness McGrane only mentioned witness Jellison in his discussion of Standard A costs by shape, USPS-RT-12, pp. 8-14, Tr. 35/18957-63. During oral cross-examination, witness McGrane failed to identify any criticisms he had with witness Jellison's calculation of the Standard A Regular parcel/flat cost differential or parcel revenue/cost differential. Tr. 33/18972-78.

- Even the Postal Service's identification of mailpieces as parcels as between the RPW system and IOCS is problematic.

This testimony was not rebutted either by the Postal Service or by any other party.

Witness Jellison criticized the Postal Service's proposal (PSA-T-1, pp. 21-23, 28, 30, Tr. 24/12965-67, 12973, 12975), pointing out that:

- The Postal Service was unable to identify whether the parcel/flat cost differentials reflected the **weight** or the **shape** of the mailpiece;
- The Postal Service's Standard A parcel **volume** data reflected shape determinations expressed on mailing statements,⁴⁹ while Standard A parcel **cost** data do not reference mailing statement data;
- The Postal Service acknowledged that individuals who collect the data used to develop shape-based nonletter mail processing costs may confuse parcels and flats;
- Even without a parcel surcharge, the Postal Service's rates may reflect greater rate averaging between letters and nonletters than exists between parcels and flats;⁵⁰ and
- The actual revenue/cost difference for Standard A regular parcels (88.5 percent of all BY 1996 Standard A parcels) is less than 4.9 cents.⁵¹

Again, this testimony was not rebutted either by the Postal Service or by any other party.

⁴⁹ Further, there is no current incentive for such mailing statements to distinguish accurately between Standard A flats and parcels, since Standard A nonletter rates do not distinguish between flats and parcels.

⁵⁰ See response to USPS/PSA-T1-38, Tr. 24/13044-45.

⁵¹ In other words, notwithstanding the unrebutted fact that the actual revenue/cost differential for all Standard A Regular parcels is well below the proposed 10 cent amount, the Postal Service's proposal would saddle all Standard A parcels with an identical surcharge.

2. The Postal Service Attempted to Rebut the Criticisms of Only One Intervenor Adverse to the Surcharge

Witness Andrew testified that Postal Service witness Crum (RIAA, *et al.*-T-1, pp. 15-17, 20-27, Tr. 22/11662-64, 11667-74):

- overstated the Standard A parcel/flat **mail processing** cost differential by **2.33** cents per piece; and
- overstated the Standard A parcel/flat **transportation** cost differential by **3.28** cents per piece.

Witness Degen, USPS-RT-6, addressed witness Andrew's criticism of witness Crum's calculation of the Standard A parcel/flat **mail processing** cost differential in his rebuttal testimony. *Id.*, pp. 44-46, Tr. 36/19362-64. "Witness Andrew's criticism may have theoretical validity, but, in this instance, the empirical results show that [the need to distribute non-MODS costs by subgroups] is not a problem." *Id.*, p. 45, ll. 6-8, Tr. 36/19363. However, witness Degen never specifically disputed witness Andrew's conclusion that witness Crum had overstated the Standard A parcel/flat **mail processing** cost differential by 2.33 cents per piece. Tr. 36/19369, l. 17 to 19370, l. 18., 19372, ll. 17-21. On cross-examination, witness McGrane expressly admitted that he did not rebut these analyses, Tr. 35/18979, ll. 12-16.

Witness Andrew's evidence that Standard A parcel costs were overstated by 5.6 cents is particularly significant in light of the data regarding the BY 1996 Standard A Regular parcel revenue/cost differential. Standard A Regular which constituted 88.5 percent of the total BY 1996 Standard A parcel volume, may not have faced a "below cost-rate problem" during the Base Year — revenues exceeded costs. *See* witness

McGrane's agreement to this "hypothetical," Tr. 35/18980, ll. 16-22; 18981, ll. 16-23. Furthermore, the Postal Service's proposed Standard A Residual Shape surcharge would constitute a textbook example of cross-subsidy, taking revenues from Standard A parcels, which cover their costs, to make up the revenue/cost deficit of Standard A ECR and Nonprofit parcels, which do not.

Regardless of whether the Commission agrees that no "below cost-rate problem" exists for Standard A Regular parcels, it is abundantly clear that the evidence in this docket is insufficient for the Commission to recommend the Postal Service's Standard A residual shape surcharge.

3. The Focus on Costs Incurred by Shape, While Ignoring Costs Avoided by Shape, By Refusing to Permit Dropship Discounts, Is Inconsistent, Unfair, and Inequitable

Dr. Haldi criticized the Postal Service's inconsistency in rate design. Using a bottom-up cost exercise, Postal Service goes to great lengths to ensure that parcels, which incur extra transportation and mail processing costs, pay those costs through a surcharge. However, the Postal Service makes no attempt whatsoever to provide parcel mailers who enter their parcels at DSCFs and DDUs, and avoid most or all of those extra transportation and mail processing costs, an opportunity to avoid some or all of the surcharge. As Dr. Haldi stated, "the more it costs to sort something, the greater is the cost avoidance from presortation." NDMS-T-3, p. 33, Tr. 23/12164.

Witness Crum's calculation of the total respective **costs incurred** by Standard A flats and parcels carefully distinguishes the respective costs incurred by shape for each of 19 cost categories. *See* USPS-T-28, Exhibit K, Table 3. However, when witness Crum adjusted the parcel/flat cost differential to account for differing degrees of **presort** and depth of **dropshipment** between parcels and flats, all of his calculations which incorporated **presort** and **dropshipment cost avoidance** (drawn from LR-H-111) assumed that cost-driving characteristics such as shape and weight do not affect **costs avoided** the same way they affect **costs incurred**.

The reasoning that underlies this rate design is unclear. The Postal Service established distinct Standard A parcel rates based on the belief that parcels' shape causes them to **incur** more costs than flats (of the same weight) incur, but the Postal Service then rejects the notion of parcel dropship discounts and thereby assumes that costs **avoided** by dropshipment of a parcel are identical to the costs avoided by dropshipment of a flat. The contradiction is obvious. Clearly, the Postal Service cannot have it both ways.

Nevertheless, witness Crum, in his calculations in this docket, assumes that the costs avoided by dropshipping Standard A letters, flats, and parcels are identical. Tr. 5/2361, ll. 10-15.

For example, witness Crum's calculations of the costs incurred by Standard A parcels, compared to Standard A flats and letters, reflect the fact that the different densities of letters, flats, and parcels cause them to incur different mail handling costs. But when calculating costs avoided, witness Crum uses a library reference which

assumes the different densities of Standard A parcels, flats, and letters do not result in different costs being avoided by shape. Tr. 5/2362, l. 7 to 5/2363, l. 10. Witness Crum observed that the Library Reference he relied upon for his cost avoidance calculations, LR-H-111, did not provide costs avoided by shape. Tr. 5/2361, ll. 17-22. Witness Crum stated that he knew that Standard A parcels incur higher mail processing and transportation costs than Standard A letters, but that he **did not know** whether the reverse was true, whether the costs avoided by a Standard A parcel are higher than the costs avoided by a Standard A letter when these mail processing and transportation costs are avoided through presortation or dropshipment. Tr. 5/2367, ll. 4-10.

Witness Crum suggested that any lack of consistency in his analysis, identifying costs incurred by shape but not costs avoided by shape, was not important because the purpose of his analysis was to support a simple, “conservative” surcharge. Tr. 5/2368, ll. 7-11. His calculations inflate the actual Standard A parcel/flat cost differential by understating the degree to which additional dropshipment and presortation of flats (compared to parcels) skews the data reported in USPS-T-28, Exhibit K, Table 3.

Postal Service witness McGrane’s rebuttal testimony criticized an intervenor witness for making “an ‘apple to orange’ comparison.” USPS-RT-12, p. 9, Tr. 35/18958. Yet witness Crum’s calculation of the parcel/flat cost differential is subject to a similar criticism: bottom-up costs incurred are adjusted to reflect shape-based differences, but top-down costs avoided **are not adjusted**. Fairness and equity require consistency in cost estimates. If witness Crum can use averaged costs to adjust the parcel/flat cost differential (to reflect shape-based variances in depth of dropshipment

and degree of presortation), he should also substitute averaged mail processing and transportation costs when calculating the parcel/flat cost differential. Just as Postal Service witness McGrane called for an “‘apples to apples’ comparison, so witness Haldi asked the Commission either to:

- Estimate the cost of parcels using average transportation costs for letters, flats and parcels combined, consistent with the average transportation costs used to develop destination entry discounts; or
- De-average the destination entry discounts for parcels, using the same density that is assumed when estimating bottom up transportation costs of parcels. [NDMS-T-3, p. 40, Tr. 23/12171.]

Analyzing just transportation costs, if Standard A parcel transportation costs are recalculated using the average transportation cost for letters, flats and parcels combined, the average cost of parcels would be reduced by approximately 6.6 cents. *Id.*⁵² Mail processing costs could likewise be averaged between Standard A shapes.

Alternatively, if the Commission does not recalculate Standard A parcel transportation costs using the average cost for letters, flats and parcels combined, Dr. Haldi observes that fairness would require the Commission to “recompute separate de-averaged destination entry discounts for parcels.” *Id.*, p. 41, Tr. 23/12172. In other words, **separate parcel destination entry discounts should be recommended.** As Dr. Haldi observes, “giving parcels a destination entry discount that fully reflects cost avoidance would seem both fair and desirable in allowing mailers of parcels the opportunity to offset that portion of the surcharge being imposed.” *Id.*

⁵² As was discussed above regarding witness Andrew’s analysis that witness Crum overstated parcel costs by 5.6 cents, this recalculation of parcel transportation costs would eliminate any Standard A Regular parcel “below cost-rate problem,” and reduce the combined Standard A parcel revenue/cost differential (in this instance, to 1.6 cents).

C. The Postal Service's Proposed Standard A Residual Shape Surcharge Does Not Consider Rate Shock on Standard A Parcel Mailers

In past dockets, the Postal Service and the Postal Rate Commission have limited the magnitude of rate increases. Commonly, the upper limit has been set at approximately twice the average increase. For example, in Docket No. R90-1, where the Postal Service first introduced shape-based rates for third-class mail, Postal Service witness Mitchell:

identifies his initial policy guidance as an (i) overall constraint on the range of rate increases and decreases (no decreases greater than 10 percent and no increases greater than 35 percent) and (ii) the average 17 percent increase for regular rate and 23 percent for nonprofit. USPS-T-20 at 101; *Id.* at 73. Separate but related policy considerations — applied in a more category specific sense — include principles witness Mitchell describes as “honoring past relationships” and “easing the adjustment burden” on the mailers. We consider both of these part of his broad consideration of the impact or effect of the changes on mailers. *Op. & Rec. Dec.*, Docket No. R90-1, p. V-235.

Note that the Postal Service proposed an average increase of 17 percent, and a maximum rate category increase of 35 percent. In turn, the Commission recommended an average increase of 25 percent, and a maximum increase of 41.7 percent. *Id.*, p. V-246, n.52.

In this case the Postal Service proposes an average increase of 4.1 percent in Standard A commercial (Exhibit USPS-30D), and set an “upper limit” of 10 percent for Standard A commercial. *See* response to NAA/USPS-T36-12, Tr. 6/2786. However, witness Moeller assigned a 55.1 percent increase to Standard A Mail DSCF entry minimum-per-piece 3/5 digit presort parcels. *See* response to NAA/USPS-T36-4, Tr. 6/2777.

When witness Moeller was questioned regarding his proposed worksharing passthroughs — that exceeded 100 percent — he observed that “we need to be aware of changes in rates and incentives we have given to mailers to take on a lot of...capital investment or capital expenditures.” Tr. 7/3153, ll. 11-20. Yet this principle was not applied to Standard A parcel shippers. As Dr. Haldi discussed, photofinishers currently ship a significant volume of their mailpieces as mixed parcels (*i.e.*, flats and parcels combined), which reflects the current reality that flat and parcel “nonletters” pay the same rates. The proposed surcharge will force photofinishers either to pay the surcharge on all nonletter mailpieces, or to invest additional resources in sorting and shipping flats separate from parcels, another expense imposed on these mailers over and above the 50 percent increase in their Standard A parcel rates (DSCF-entry 3/5 digit presort). *See* NDMS-T-3, pp. 5, 10, Tr. 23/12136, 12141; and Tr. 23/12244, l. 16 to 12245, l. 9.

The closest the Postal Service comes to acknowledging the adverse impact of the surcharge on Standard A parcel mailers is the statement by witness Moeller in response to DMA/USPS-T36-3 (Tr. 6/2740):

On page 13, line 15 of my testimony, I state that the low passthrough for the surcharge helps mitigate the impact of the effective rate change for residual shape mail.

When asked whether there was a maximum desirable rate increase for a given rate cell, expressed as a multiple of the average rate increase for the subclass, witness Moeller stated that he does not believe “a rule involving a multiple of the average increase is the best way to consider the effect of rate increases on mailers.” He went

on to observe that, while the 10-percent cap is approximately 2-3 times the average rate increase for the Regular and ECR subclasses, he would not extrapolate that increases of 40 to 60 percent would be acceptable where there was an average increase of 20 percent. *See* response to VP-CW/USPS-T36-5, Tr. 6/2899. Witness Moeller's proposed residual shape surcharge appears to apply the principle that increases of 40 to 60 percent are acceptable where the average rate increases are only 4-5 percent.

D. The Postal Service Proposal Does Not Meet the Statutory Standards For Mail Classification and Rate Design

As discussed above, the Postal Service's filing in **Docket No. R97-1** requested changes to the Domestic Mail Classification Schedule. Request, Attachment A, pp. 25-26, 29. Section 3623(c) sets forth six criteria for mail classification changes, and the Postal Service's proposed Standard A residual shape surcharge does not meet the relevant statutory standards.

1. The Postal Service's Proposed Surcharge Does Not Promote a Fair and Equitable Classification System for All Mail Under 39 U.S.C. Section 3623(c)(1)

As discussed above, the Postal Service's proposed Standard A residual shape surcharge may have the effect of taking additional revenues from Standard A Regular parcels, which cover their costs, to compensate the Postal Service for the revenue/cost deficit of Standard A ECR and Nonprofit parcels, which do not. This result would not meet any standard of fairness and equity.

Additionally, the Postal Service's proposed surcharge creates a classification which combines parcels from four separate subclasses. This proposal evidently **creates a single classification** across subclasses, rather than four classifications, since the cost data underlying the surcharge incorporate the costs incurred by all Standard A commercial **and** Nonprofit parcels. Thus, if this proposal is recommended, and the Postal Service's methodology is retained for the next omnibus rate case, we can expect another sharp increase in Standard A Nonprofit attributable costs would likely result in *an increase to the surcharge paid by Standard A Regular parcels, even if revenues from Standard A Regular parcel continue to increase vis-a-vis their costs.* Allowing the costs incurred by one subclass of mail to dictate the rates paid by a separate subclass of mail is not fair and equitable.

2. The Postal Service Has Not Demonstrated the Desirability of or Justification for this New Classification Under 39 U.S.C. Section 3623(c)(2)

The Postal Service's proposed surcharge does not affect the relative value of Standard A Regular, Standard A ECR, and Standard A Nonprofit parcels to the people, nor has the Postal Service demonstrated the desirability or justification for its proposed new classification. There is no explanation why it is desirable to combine mailpieces from four separate subclasses simply because they share similar shape criteria.

The Postal Service does not claim that its proposal is justified by continuation of a "below cost-rate problem." There is no clear demonstration that increasing the postage and mailing costs (*i.e.*, the separation of flats from parcels discussed above)

incurred by Standard A parcel mailers provides commensurate benefits to the Postal Service. No mailer has submitted any evidence or testimony in this record (or that of Docket No. MC95-1) that could support the claim that this proposal is in any way desirable to them.

E. **The Proposed Surcharge May Result in Unintended and Undesirable Consequences**

Dr. Haldi points out in his testimony that, if the Commission were to recommend the proposed Standard A residual shape surcharge, the additional expense from the surcharge could be avoided by repackaging the contents of a parcel-shaped package into a mailpiece with flat-shaped dimensions. NDMS-T-3, p. 13, Tr. 23/12144. The impact of the proposed surcharge could be, as Dr. Haldi described it, staggering. *Id.*

Witness Moeller observed regarding rate changes of 0.2 or 0.3 cents:

I think people fight over much smaller increases, you know, so I think, yes, that could mean a lot to somebody, especially if, as you stated earlier, that there are some mailers that are in those particular rate categories and all their mail got a three-tenths-of-a-cent increase, you multiply that times some volume, that's — that's a big amount of money. [Tr. 6/3115, ll. 6-12.]

If increases of two or three-tenths of a cent are “a big amount of money” when “you multiply that times some volume,” the effect of a **10 cent** increase on large volumes of highly workshared mail, **combined** with the Postal Service's other proposed increases

of up to 10 percent to Standard A Mail,⁵³ will not go unnoticed by Standard A parcel mailers. Facing rate increases over 50 percent, “one can predict with a high degree of confidence that virtually all parcel mailers whose product gives them a repackaging option will in fact seek to repack their products into flat-shaped mailpieces.”

NDMS-T-3, p. 14, Tr. 23/12145. In fact, in response to this docket, Standard A parcel mailers are already exploring repackaging to flats. Response to USPS/NDMS-T3-42, Tr. 23/12232. However, as Dr. Haldi points out, “‘flat-shaped’ is not necessarily synonymous with ‘easy-to-handle’ or ‘low-cost.’” NDMS-T-3, p. 15, Tr. 23/12146.

While the variety of parcel shapes and sizes has been a topic of discussion over several dockets (*see, e.g.*, Dissenting Opinion of Vice Chairman W.H. “Trey” LeBlanc, Docket No. MC95-1, page 1), Dr. Haldi raises in this docket the fact that “some flat-shaped mailpieces can be more awkward to handle than many parcels in their existing shape, and can present carriers with new problems in delivery.” NDMS-T-3, p. 15, Tr. 23/12146. Notwithstanding its inexplicable expectation that Standard A parcel volume will increase 22 percent between the Base Year and the Test Year, the Postal Service acknowledges that some Standard A parcel volume will migrate to flats.⁵⁴ However, the Postal Service appears to assume that the Standard A parcel volume will migrate to flats which have the cost characteristics of current Standard A flats. Dr.

⁵³ Response to USPS/NDMS-T3-6, Tr. 23/12187.

⁵⁴ Witness Moeller said that it was no secret that “some parcel mailers may ...be able to avoid the surcharge by mailing their smaller parcels as flats.” (Tr. 7/3162, ll. 7-11).

Haldi points out that the repackaging of Standard A parcels into flats may impose significant extra costs on the Postal Service, compared with the costs incurred in handling parcels in their present shape. *Id.*, p. 16, Tr. 23/12147. As a result,

The added costs imposed on the Postal Service by the more cumbersome handling of either close-to-maximum size rigid boxes or compartmentalized envelopes created by repackaging could very well exceed any added revenue obtained from the parcel surcharge on those packages that do not convert.... [*Id.*, p. 18, Tr. 23/12149.]

Additionally, if the proposed surcharge causes significant volumes of Standard A Regular parcels, but not parcels from other subclasses, to migrate to flats, the surcharge may result in a greater Standard A parcel revenue/cost disparity than existed before the surcharge. The revenue/cost differentials of Standard A ECR and Standard A Nonprofit parcels are far greater than that of Standard A Regular parcels. *See* USPS-T-28, Exhibit K, Tables 1, 2, 3A(1), 3A(2), and 3B(2).

Finally, the surcharge will impose additional costs on Standard A parcel mailers who can currently ship a significant volume of their mailpieces as mixed parcels (*i.e.*, flats and parcels combined), since flats and parcels pay the same rates. The proposed surcharge will force such mailers either to pay the surcharge on all nonletter mailpieces, or to invest additional resources in sorting and shipping flats separate from parcels — another expense imposed on these mailers over and above the up to and over 50 percent rate increases in their Standard A parcel rates. *See* NDMS-T-3, pp. 5, 10, Tr. 23/12136, 12141; and Tr. 23/12244, l. 16 to 12245, l. 9.

F. NDMS and Merck-Medco Recommendations

NDMS and Merck-Medco submit that, for all these reasons, the proposed Standard A residual shape surcharge proposal should not be recommended by the Commission. In the alternative, NDMS and Merck-Medco offer the following recommendations:

1. The Commission Should Create a Shell Classification

Should the Commission feel that some action is necessary at this time, it should accept Dr. Haldi's alternate proposal and consider recommending a shell classification, without any specific rate, and request the Postal Service to submit a new proposal which addresses the more important deficiencies of the current proposal. For example, a new proposal could distinguish between those parcels which evidently do not have a "below cost-rate problem" (Standard A Regular parcels, which were 88.5 percent of the Base Year Standard A parcel volume) and other parcels which apparently do have this problem.

2. The Surcharge Should not be More than 2 or 3 Cents

Should the Commission nevertheless feel compelled to go beyond a shell classification, then the Commission should accept Dr. Haldi's proposal that the surcharge not exceed 2 to 3 cents. The evidence in this docket indicates that, to the extent that there is a "below cost-rate problem" with Standard A parcels, the extent of that problem is not more than 2 to 3 cents. In fact, the surcharge should probably be less. On the record of this docket, with unrebutted testimony documenting the

incompleteness and inconsistency of the Postal Service's evidence presented in support of the surcharge, there should not be a 100 percent passthrough of this 2-3 cent revenue/cost differential.

3. The Commission Should Create Separate Destination Entry Discounts for Parcels, Reflecting the Avoidance of Greater Costs

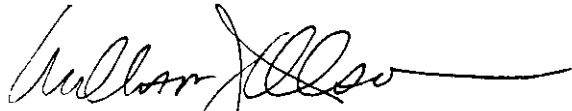
Should the Commission adopt witness Crum's de-averaged bottom-up costs as the basis for a surcharge at this time, and recommend the Postal Service's proposed 10 cent surcharge, separate parcel destination entry discounts should be recommended which reflect parcels' avoidance of the same shape-based costs the incurrence of which which were relied upon by witness Crum to justify the parcel surcharge.⁵⁵

⁵⁵ The practice of recognizing shape as a cost-driving characteristic of discounts in Standard A/third-class mail is already well-established. In Docket No. R90-1, when the Commission first recommended **shape-based** rate categories for third-class mail, the **presort discounts** for **nonletters** were **larger** than those for **letters**, *e.g.*, carrier route letters were discounted 6.2 cents/piece, while carrier route nonletters were discounted 8.6 cents per piece. These shape-based discounts were part of the Postal Service's request, and were supported by two studies (by Postal Service witnesses Shipe and Moeller). *Op. & Rec. Dec.*, Docket No. R90-1, pp. V-159, V-225, V-236.

CONCLUSION

NDMS submit that their testimony filed herein support their rate and classification proposals, and that the Postal Service's request with respect to the First-Class nonstandard surcharge, Priority Mail and the proposed Standard Mail A parcel surcharge should be modified or rejected as set forth in Dr. Haldi's testimony.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'William J. Olson', written over a horizontal line.

William J. Olson

John S. Miles

Alan Woll

John F. Callender, Jr.

WILLIAM J. OLSON, P.C.

8180 Greensboro Dr., Suite 1070

McLean, Virginia 22102-3823

(703) 356-5070

Counsel for Nashua Photo Inc.,

District Photo Inc.,

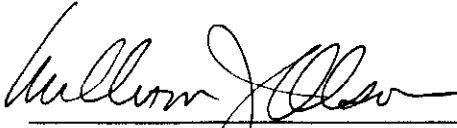
Mystic Color Lab,

Seattle FilmWorks, Inc., and

Merck-Medco Managed Care, L.L.C.

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with Section 12 of the Rules of Practice.



William J. Olson

April 1, 1998